STRATEGIC PLANNING, RESOURCE ALLOCATION AND CRISIS MANAGEMENT—IS THE SEC READY?

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT EFFICIENCY AND FINANCIAL MANAGEMENT

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

APRIL 20, 2004

Serial No. 108–177

Printed for the use of the Committee on Government Reform

Available via the World Wide Web: http://www.gpo.gov/congress/house
http://www.house.gov/reform

U.S. GOVERNMENT PRINTING OFFICE

95–221 PDF WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON GOVERNMENT REFORM

TOM DAVIS, Virginia, *Chairman*

DAN BURTON, Indiana
CHRISTOPHER SHAYS, Connecticut
ILEANA ROS-LEHTINEN, Florida
JOHN M. McHUGH, New York
JOHN L. MICA, Florida
MARK E. SOUDER, Indiana
STEVEN C. LaTOURETTE, Ohio
DOUG OSE, California
RON LEWIS, Kentucky
JO ANN DAVIS, Virginia
TODD RUSSELL PLATTS, Pennsylvania
CHRIS CANNON, Utah
ADAM H. PUTNAM, Florida
EDWARD L. SCHROCK, Virginia
JOHN J. DUNCAN, Jr., Tennessee
NATHAN DEAL, Georgia
CANDICE S. MILLER, Michigan
TIM MURPHY, Pennsylvania
MICHAEL R. TURNER, Ohio
JOHN R. CARTER, Texas
MARSHA BLACKBURN, Tennessee
PATRICK J. TIBERI, Ohio
KATHERINE HARRIS, Florida

HENRY A. WAXMAN, California
TOM LANTOS, California
MAJOR R. OWENS, New York
EDOLPHUS TOWNS, New York
PAUL E. KANJORSKI, Pennsylvania
CAROLYN B. MALONEY, New York
ELIJAH E. CUMMINGS, Maryland
DENNIS J. KUCINICH, Ohio
DANNY K. DAVIS, Illinois
JOHN F. TIERNEY, Massachusetts
WM. LACY CLAY, Missouri
DIANE E. WATSON, California
STEPHEN F. LYNCH, Massachusetts
CHRIS VAN HOLLEN, Maryland
LINDA T. SANCHEZ, California
C.A. “DUTCH” RUPPERSBERGER, Maryland
ELEANOR HOLMES NORTON, District of Columbia
JIM COOPER, Tennessee
——— ———

BERNARD SANDERS, Vermont (Independent)

Melissa Wojciak, *Staff Director*
David Marin, *Deputy Staff Director*
Rob Borden, *Parliamentarian*
Teresa Austin, *Chief Clerk*
Phil Barnett, *Minority Chief of Staff/Chief Counsel*

Subcommittee on Government Efficiency and Financial Management

TODD RUSSELL PLATTS, Pennsylvania, *Chairman*

MARSHA BLACKBURN, Tennessee
STEVEN C. LaTOURETTE, Ohio
CANDICE S. MILLER, Michigan
MICHAEL R. TURNER, Ohio
KATHERINE HARRIS, Florida

EDOLPHUS TOWNS, New York
PAUL E. KANJORSKI, Pennsylvania
MAJOR R. OWENS, New York
CAROLYN B. MALONEY, New York

Ex Officio

TOM DAVIS, Virginia
HENRY A. WAXMAN, California

Mike Hettinger, *Staff Director*
Larry Brady, *Professional Staff Member*
Sara D'Orsie, *Clerk*
Mark Stephenson, *Minority Professional Staff Member*

CONTENTS

STRATEGIC PLANNING, RESOURCE ALLOCATION AND CRISIS MANAGEMENT—IS THE SEC READY?

TUESDAY, APRIL 20, 2004

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT EFFICIENCY AND FINANCIAL MANAGEMENT,
COMMITTEE ON GOVERNMENT REFORM,
New York, NY.

The subcommittee met, pursuant to notice, at 10:30 a.m., at the Michael Schimmel Center for the Arts, Pace University, New York, NY, Hon. Todd Russell Platts (chairman of the subcommittee) presiding.

Present: Representatives Platts and Towns.

Staff present: Michael Hettinger, staff director; Larry Brady and Tabetha Mueller, professional staff members; and Adam Bordes and Andrew Delia, minority professional staff members.

Mr. PLATTS. A quorum being present at this field hearing of the Subcommittee on Government Efficiency and Financial Management will come to order.

We are pleased to be here in New York City today to conduct an important oversight hearing into strategic planning and resource allocation at the Securities and Exchange Commission.

I certainly would like to take this opportunity to thank our subcommittee's ranking member, Ed Towns, for his active participation in helping to arrange this hearing and helping to ensure that the SEC is effectively regulating the mutual fund industry, the focus of our hearing in resource allocation today. So, Ed, thanks for your assistance.

We appreciate not just Ed's hospitality in being here today, but also Pace University. We're delighted to be here on campus and appreciate you hosting as well.

We are here today because we believe Chairman William Donaldson and his senior staff at the Securities and Exchange Commission have made great strides toward making strategic planning at the SEC a priority. However, we also believe there is more work to be done.

The Commission is responding to unprecedented challenges. We have seen corporate accounting scandals and illegal practices in the mutual fund industry, both of which have shaken the very foundation of our financial markets and undermined investor confidence. We have seen technological advances that have given more people access to investment vehicles and contributed to the globalization

of our markets, conditions that have increased the SEC's workload exponentially. Further increasing the SEC's responsibilities, Congress enacted Sarbanes-Oxley, giving the Commission a significantly larger oversight role in corporate finance. Congress also recognized the need to transform the SEC and granted pay parity and hiring flexibility to the SEC along with significant resources to hire new staff and update existing technology.

All these changes and challenges, whether good or bad, require a bold and creative strategic focus. One of the most important challenges today for the SEC will be responding effectively to the mutual fund crisis. The mutual fund industry is critical to the health of our economy. More than half of all U.S. households, 91 million investors, are invested in mutual funds to the tune of $7.5 trillion. If the SEC's goal is to protect the maximum number of individual investors, effective regulation and enforcement of the mutual fund industry should be of the highest priority.

The SEC responded to this most recent crisis with aggressive rulemaking initiatives. Congress is considering several avenues to reform the industry. Regardless of which rules and laws are finally enacted, it is effective regulation and enforcement that will make the difference. This subcommittee believes that regulation enforcement is accomplished, in part, by effective strategic planning which directs resources where they will have the greatest impact.

The subcommittee is grateful to Attorney General Eliot Spitzer for his work in prosecuting perpetrators of the mutual fund scandals, and we are certainly honored to have the Attorney General here today to discuss his successful enforcement efforts, and we appreciate your being with us.

Of course, prosecuting criminals is only one side of the equation; effective regulation is the other. The use of statistical modeling and data mining can greatly enhance regulatory efforts. One example is a recent study conducted by Dr. Morey, from here at Pace University, who will testify today about a method he developed to detect "window dressing" in bond funds. With the appropriate technology and staff with the right expertise, the SEC can be more proactive as it polices the mutual fund industry and looks out for investors large and small every day.

With the right strategic focus as a blueprint, the new resources for technology and human resources can be put to use in the most effective manner. Oversight of strategic planning at the Commission has been a high priority for this subcommittee. Our July 2003 hearing was encouraging, and we applaud the continuing joint efforts of Rick Hillman and his team at the General Accounting Office and the Office of the Executive Director at the SEC, Jim McConnell, who is here with us today. We are eager to see the fruits of your labor, and this hearing will provide a forum for an in-depth update on your progress.

We also have the benefit today of hearing from Mr. John Bogle, the founder of Vanguard Funds and a vocal advocate for improving the mutual fund industry.

I would like to thank each of our witness who will be testifying today and for your testimony you submitted in writing prior to today's hearing. We certainly look forward to your testimony.

And I now would like to yield to our ranking member, the gentleman from New York, Mr. Towns for the purposes of an opening statement.

Mr. TOWNS. Thank you, Chairman Platts.

Let me begin by thanking you for holding this hearing in my hometown, the financial capital of the world. It is the ideal place to examine how we can strengthen the oversight of our mutual fund industry. This is the century for the integrity of the financial sector in the protection of millions of investors.

I would also like to thank the Provost and Pace University for graciously hosting this hearing which has great importance to the New Yorkers, of course, and the Nation.

This hearing of the Securities and Exchange Commission is the result of a series of breakdowns in the Commission's regulatory enforcement efforts. As many know, there have been widespread reports of deceptive and fraudulent practices in the mutual fund industry, many uncovered by one of our witnesses here today, Attorney General Eliot Spitzer. For too long the SEC has been reactive to these scandals and unethical practices. We need to ensure that the SEC has the resources, tools, expertise, planning to be proactive so it can identify and prevent abuses before they happen.

Due to the recent rash of corporate scandals and mutual funds abuses there has never been a greater need for the SEC to fulfil its mission, which is to protect investors and maintain the integrity of the securities market. The Congress has attempted to assist the SEC in restoring confidence through the enactment of the Sarbanes-Oxley Act. However, such laws and regulations will be futile without effective enforcement. Making matters more challenging, the SEC's workload has been growing exponentially. Today more Americans are invested in stock and other capital markets. According to the General Accounting Office, mutual funds have grown from a $400 billion industry to one with $7.5 trillion in assets during the past two decades. In fact, more than 95 million Americans invest in mutual funds. These numbers speak to the importance of maintaining the integrity of the mutual fund industry.

The Congress significantly increased the SEC's financial resources. Last fiscal year the SEC received appropriations to hire 842 new employees to help meet the increasing workload. In fact, over the last 2 years the Commission has had an appropriation increase of 73 percent. Congress has given the SEC special flexibility to set wages and hire employees so they can compete for the best and the brightest. However, in spite of these efforts there are still more than 500 employee vacancies remaining of the newly created permanent positions.

We need to know why the vacancies continue to exist. If there is something that we need to do in Congress to help fix this.

I am hopeful that Mr. McConnell will shed some light on this issue by presenting a detailed information on how the SEC will utilize its resources and what hurdles remain in producing a concise strategic plan.

I am also anxious to hear from today's witnesses on the areas they believe the SEC needs to focus on to improve its oversight.

I look forward to the testimony of Attorney General Spitzer, who has been instrumental in uncovering numerous abuse practices within the industry.

On that note, Mr. Chairman, I yield back.

Mr. PLATTS. Thank you, Mr. Towns.

We will proceed to the testimony from our panels. Certainly first, as is evident, the Attorney General we will have your statement and then questions, and then we will go to our second panel with Dr. Morey and Mr. Bogle. And then our third panel with Mr. McConnell and Mr. Hillman.

So, Attorney General Spitzer, if you would like to begin.

Actually, I need to swear you in first. If I could have you stand and take the oath.

[Witness sworn].

Mr. PLATTS. The clerk will reflect that the witness has answered the oath in the affirmative.

And Attorney General Spitzer, the floor is yours.

STATEMENT OF ELIOT SPITZER, ATTORNEY GENERAL, NEW YORK

Mr. SPITZER. Thank you, Mr. Chairman and Congressman Towns. It's a pleasure to be here. Thank you for visiting New York and having this hearing, and thank you also to the other witnesses and Pace University.

I want to congratulate Mr. Bogle on having made what we call the Times 100, the 100 most important people in the world, I think it is, being somewhat akin to the Fortune 500 for individuals. Mr. Bogle years, perhaps even decades speaking for the issues that we are dealing about and talking about today and what has been recognized and what we are getting to recognize, and quite rightly so.

I wanted to begin by putting into something of a theoretical framework many of the issues that have troubled the financial securities industry over the last number of years, and suggest to you that really two polices that have been intentionally adopted by Congress by our regulatory framework have collided in the past number of years to generate the problems that we have encountered, problems that have manifested themselves in research that was being marketed to individuals that was improper, and I truly believe problems in the mutual fund context and other problems that will in due course emerge, perhaps.

And these are two policies are, first, an intentional effort to promote concentration within the financial services sector, and this is what I call the city group model where Congress over a number of years, actually it was regulatory agencies initially and then Congress, affirmatively repealing Glass-Stegall, has encouraged our financial services sector to seek additional concentration.

The underlying motivation for this was, first, a sense that the historical rationale for enacting the Glass-Stegall perhaps was flawed. And second, a concern that capital concentration overseas in the European and the Asian banks were getting to the point where competition in the U.S. banks would get to the point where U.S. banks, U.S. financial service companies could not compete. So we were driven by what were, perhaps, wise decisions, perhaps not. But certainly an agreed upon policy to seek additional concentra-

tion in the financial services sector. And therefore, we continued to see larger and larger financial service sector companies that all wanted opportunities, provide opportunities for one-stop-shopping for clients whether it be a major company or an individual can obtain any product at that one entity, whether its Citi, Morgan Chase, Bank One, etc., we obviously have seen and continue to see this increased concentration.

The other policy that is also unambiguously and affirmative one as the first one that I suppose some would question. The second policy is one of encouraging all Americans into the capital markets. And, Mr. Chairman, you referred to this when you gave the numbers that now capture the enormity of the mutual fund sector, 91 million Americans and over $7 trillion. We have seen what we call this democratization of the capital markets over the last number of decades. This has been unambiguously good both for the markets and for the individual investors. It has encouraged, and we have encouraged and rightly so, Americans to take their savings to invest them in equities and generate and participate in the growth that resulted there from.

The problem that we have, unfortunately, is that the interface between these two policies has been uncomfortable. We have larger and larger financial service sector companies dealing with more atomized investors. And rather than seeing these investors and individuals whom you owe fiduciary duty and figuring out how to live up to that fiduciary duty, we have seen the financial service companies view these investors as fee generators. When they are viewed as fee generators rather than an individual to whom you will owe a fiduciary duty, unfortunate things can result. That is, I think, what binds together the issue of improper research that we were addressing last year, the issue in the mutual fund context where we have seen fees spiral out of control, and other contexts where we see smaller, smaller investors not getting the advice, not getting the benefits of the fiduciary duty that is owed to them, but rather the view is they're taken advantage of to generate fees.

Now, I am not suggesting, obviously, that either one of these policies necessarily should be reversed. What I am suggesting, I said the same thing to the CEOs of the companies that have increasedly dominated our financial services sector, that these companies and of course the regulators who deal with these issues, need to figure out how to generate an interface between the small investor and the large financial service sector companies that will provide proper protection for the fiduciary duties that is owed to the investor. That is the difficulty, the problem, the issue that has confronted you on these companies. It is one they have to think about very deeply because if they don't answer it, then I think they will see not only increasingly regulatory response, but also they will see their customers move away to other entities. And so for business rationale as well as basic obligations of ethics, these companies need to address this issue. And I hope, certainly, that they do so down the road.

And I can tell you that the issues that we continue to look at that are far afield from the issues that have already made their way into the public area, are issues that go to the fore, issue of is

a fiduciary duty being breached. That is the issue that binds together our concerns, at least in my office.

Let me quickly, if I might go through the three distinct chapters that I have seen emerge in the mutual fund investigation. I remind you that the entire period of this inquiry, at least from a public perspective, is hardly 8 months old. This issue as to what was reached publicly right after September 3rd, right after Labor Day of 2003 and over the succeeding 8 months we have succeeded in returning close to $2 billion to investors. I think it is amazing and even addressing some of the fundamental structural problems that the industry has to confront. And so we have made good progress, I think, considering the speed and the timeframe that this issue has been in the public arena.

Chapter one simply dealt with the trading violations that were diagnosed and laid out in the Narry affidavit last September 3rd, those related to the late trading and the timing issues. Late trading, obviously, being in our view almost a per se or indeed a per se violation where trades were put in after the NAB had been determined after the 4 p.m. deadline. Timing being a slightly more subtle issue and the legality or illegalities of timing is contingent to time with respect to statements of the individual mutual fund. But those two issues frame the first aspect of the debate.

I think the good news is that these are issues that merely by being exposed got resolved. It is increasingly difficult to have to believe for traders now to put in their trades after the NAB has been set, not only because the individuals are more weary of being caught but because there is an enormous and exponentially greater degree of scrutiny to that potential abuse. And so that practice certainly has diminished, if not been eliminated.

In addition the SEC has proposed certain rules with respect to the 4 p.m. deadline that would make it at a regulatory level that much easier to prosecute those cases.

The issue of timing, as well, has been diminished. We have seen diminution in the volume of money that has been sloshing around these various hedge funds dedicated to time abuses. We have seen, again, an exponentially greater effort on the part of the mutual funds to crack down on timing. And I have believe, although it is hard to statistically measure, that we have seen a dramatic reduction in the quid pro quo arrangements that have been struck where people would give so called sticky assets to mutual funds in return for the opportunity to take advantage in that capacity.

So I think that with respect to chapter one, the old saying, if sunlight is the best disinfectant, by exposing these problems, we have to a certain extent remedied them, which is not to say a more defined regulatory and/or legislative response is not appropriate. But I think chapter one by revealing the problems we also began to solve the problems.

Chapter two in my analysis, at least, is the issue of fees. And here numerically we are dealing with an issue that is greater in terms of measuring harm, if more harm is imposed or inflicted upon ordinary investors by the what I consider to be exorbitant fee structure that the mutual funds industry has managed to impose upon investors than the magnitude of harm imposed by late trading and time. Even though billions of dollars of harm have been im-

posed by late trading and timing, we think we tend to donate the dollars of harm have been imposed upon investors every year by virtue of improper fee structure.

It is not merely an issue of disclosure, although I think every committee in front of which I have testified from both sides of the aisle there has been nearly unanimous agreement that the disclosures that have been made by the fund companies have been woefully inadequate and it is impossible for most people to parse the mutual fund prospectuses and have any real sense of what fees they are paying and what the impact of those fees is upon their annualized return. And it is in this context that I refer to, you know, one of my favorite cliches, but compound interest is the eighth wonder of the world. When you look at the impact of the 1 or 2 percent differential between fees that are being charged or a 30 or 40 basis point differential between fees that are being charged and fees that should be charged, you say to people 30 basis points they either do not understand what basis points are, it sounds so de minimus, they say well big deal. But when you run the numbers and compound that differential over the long term, it essentially eliminates whatever upside might have existed by virtue of the performance of the mutual fund or in fact accentuates the lack of performance and drives investors into the issue where compared to having an index fund, they end up in a negative position.

Therefore, the fees that are charged by mutual fund companies must be addressed by this committee, by the SEC, by other regulatory entities. In the settlements in my office struck with mutual fund companies, we have obligated them to discount their fees for a period of 5 years by a significant number, hundreds of millions of dollars of benefits have accrued to investors by virtue of our settlements. There was a response to that, which a skeptical response by some who said are you involved in price fixing by virtue of what you are doing. And the answer I will give you is a resounding no. And here is why.

We have not said we have not arbitrarily or unilaterally taken a fee and said this is what you will charge and this is what you must charge. What we have said to mutual fund companies is in every instance is we conclude a differential between what you were charging the individual investors and what you were charging institutional investors for identical services. Where there is that gap, that delta, it cannot be justified because if they do an apples-to-apples comparison you are charging one group of investors who actually negotiate for the fees that are charged a certain fee. And you charge others who are relying upon a board to negotiate for them, you charge them a higher fee. Then this reflects to me a failure of negotiation, a failure to live up to the fiduciary duty that's owed to the small investor. And consequently a pawn that has been imposed upon the small investor that should not have been imposed on them. And we have said to the fund companies therefore we think that in order to remedy you improper behavior here, you could give a discount that would begin a process of moving your fees back to where the market would bring them if you would have behaved in the marketplace the way you should have. That is why we have delved into this fee issue. It is an issue that has imposed,

as I said, tens of billions of dollars of harm upon investors, and we will continue to do this.

Let me say that there has been a bit of back and forth between my office and the SEC on this issue. It is an area where we have agreed to disagree, and I think the record is clear that we are able, in fact are very successfully moving forward with settlements even though we disagree on this issue. I believe deeply the fees should be diminished and that the market has failed because the board did not act properly and that we have to push for us to behave more appropriately, that the SEC is moving forward with us to settle with the companies on issues A and B, reform and restitution while we also get settlements with the fund companies on fees. So we are managing to overcome our difference there, which takes me to issue three. Issue one was late trading timing issue, issue two was fees, issue three in board behavior.

As in so many instances that have emerged over the last couple of years where we have seen violations in the corporate arena, ultimately it comes down to a board that was not paying attention. What we have seen in the mutual fund context, unfortunately, is that the board of the fund companies have not been living up their mandate to protect the small investors. They have been all too often, and I wold refer you to Warren Buffet's shareholder letter from this year and the Berkshire Hathaway letter that is probably one of the most read investment documents every year in which he goes after, as he has for some period of time now, the mutual fund boards of directors and really is partially critical of them for not being sufficiently or indeed at all intuitive to their obligations to protect investors. Those boards, frankly, were asleep at the switch. And what we have to do is re-invigorate them and say to them live up to your duties and if you fail to do so, we will seek to have you removed. And, indeed, in the settlement that we entered with the Bank of America a couple of weeks ago now, I think the aggregate number was $675 million in restitution and fee discounts. Perhaps the most important aspect of it to me was that eight of the board members of the mutual fund board are going to be forced to cycle off the boards in reasonably short order. The reason for that is that we felt that there was a record that they failed to be properly inquisitive, failed to respond to information that should have indicated that there was ongoing timing and that there was an abuse of the investors, and their passive response to the violation of a duty that they should have, and therefore in order to reinvigorate the protection we need for investors those board members should cycle off. That is ultimately where we need to get reform. I think that is the area where legislative action is important, in the area where defining these standards of fiduciary duty is owed to investors is critically important. And as much as the SEC is doing, and I have been partially critical at various times over the last several years, to applaud them for really rolling out a sequence of rulemaking proposals that beings to address these issues, nonetheless I think legislative response is appropriate here and important in order to ensure that we have a bulwark of statutory framework that is appropriate.

One final word, and I thank you for your indulgence and I didn't mean to go on this long. And that final word relates to the regu-

latory structure in which we live. I don't want to focus on the SEC here. I want to focus on self-regulatory organizations.

The SROs over the last number of years, unfortunately, have failed our investment community. And we are seeing new leadership, very wise new leadership in New York Stock Exchange, we have seen in the NASV and other SROs as well. But I think the SROs that are supposed to be the primary and first line of defense in the investment world were not attentive to the changing dynamics and the changing structures that should have been paid attention to. I think we need to question in a very serious way whether the SROs can reform themselves, if they will live up to their critical mandate. I hope the answer is yes, but it is an issue we have to raise.

Finally, we have to ask ourselves whether the voices of industry, the ICI, the SIA, the AICPA, have not been too powerful; whether their capacity to almost define the terms of debate to Washington has unfortunately reminded the Congress and the regulatory agencies the need is immediate to examine the critical issues.

And I think the story of the AICPA after they stopped the SEC from dividing, auditing and consulting several years back is an instructive story and it tells the all too frequently told story of an industry voice that stopped a reform measure that had it been in place, probably could have prevented some of the most egregious accounting frauds that ultimately brought down some of our major companies.

So I think we need to ask ourselves whether the ICI, the AICPA, the SIA have not been woven too much into the fabric of our Washington environment to whether we need to relieve skepticism about their counsel and their perspectives as we move forward.

And thank you for the opportunity to appear before you, and certainly will try to answer your questions.

[The prepared statement of Mr Spitzer follows:]

Testimony for Subcommittee on
Government Efficiency and Financial Management
Tuesday, April 20, 2004
Pace University, New York City

Good morning. Thank you Chairman Platts and Ranking Member Towns for the opportunity to address this committee.

I want to talk to you about a series of cases brought jointly by my office and the Securities and Exchange Commission that have resulted in the return of nearly two billion dollars to mutual fund investors and significant industry reform -- all in the span of about six months since my office filed the first case in this area.

Though our philosophies of engagement have not always been identical, I believe that the SEC and I share the same over-arching goals of:

- Restoring funds to damaged investors;
- Restoring investor confidence to the marketplace; and,
- Reforming industry operating practices.

These goals have guided the steps we have taken to date from the cases we have chosen to prosecute to the remedies we have set out to achieve.

The first step in this process was to focus on the practices of late trading and market timing. Each is a discrete violation of the law. Late trading – or trading after the 4:00 P.M. close of the market -- is clearly illegal. And, market timing – the rapid in and out trades of the same fund to reap an arbitrage profit on stale prices – is a long-standing practice that becomes illegal when a manager permits it and when it is carried out in violation of what is disclosed in a fund's prospectus.

The funds we have charged all had prospectuses that clearly stated that the fund either strongly discouraged market timing or flatly prohibited the practice altogether. Nonetheless, the management

companies of these very same funds either turned a blind eye to market timers, or worse, created special arrangements with market timers in which the mutual fund's management received what are called "sticky assets," - - a payoff for granting market timers market capacity in which to time - - while long-term buy-and-hold investors got nothing except diluted shares of their investment. Fund management reaped profits, the market timers reaped profits while traditional buy-and-hold investors -- the very people mutual funds were designed for - - lost out. I won't go into the details of how investors lost money, but I would note that there have been a number academic studies quantifying the degree to which gains were reduced and losses exacerbated by these illegal trading practices. The estimates ranges from hundreds of millions to billions of dollars annually.

My office views illegal trading practices as symptomatic of a larger problem. That problem is the inherent conflict of interest that exists when the board of directors of a mutual fund board is essentially the product of the management company that created it. When this happens - - and it happens more often than not - - the board and the management company look out for each other, leaving no one to protect the interests of the fund's investors. Neither the fund boards or management companies were looking out for the millions of everyday investors whose investments were being diluted by late trading and market timing. In addition, neither the management nor the boards were offering or negotiating for the best fees. Indeed, when it came to setting the fees that retail investors would ultimately pay, the board and the management company essentially operated as a single entity negotiating with itself – about as far away from an arm's length relationship as one can get. And the result was that investors were cheated. They paid more than they should have – and that was wrong.

To address this fundamental flaw in the market, I required fee reductions in each of the settlements that my office has finalized. The SEC has opted not to address fees its settlements and we have respectfully "agreed to disagree" on this particular issue, while continuing to jointly investigate and resolve these cases.

Now in this regard, I would like to take a moment to address a criticism that has arisen. The fee reductions have prompted complaints from some that I was somehow interfering with the proper functioning of the market. I would note that at no time did I set a particular fee or make any declaration regarding what an appropriate fee is or should be. Instead, what I suggested was that funds be required to demonstrate the "reasonableness" of their fees. Specifically, the funds should do what the boards should have been doing all along, which is to ask: "Is there a difference between fees charged institutional investors and retail investors for the same advisory services? And if so, why?"

If that question was asked and honestly answered, it would have been revealed that retail investors were being overcharged for management services at many funds. We are now requiring those funds to do what is fair and right – which is to give back those overcharges and to do the job they were always supposed to do -- which is stick up for the rights of small investors. And that, I think, is progress.

Now the most recent chapter in the cases that my office and the SEC have pursued together illustrates what is perhaps the ultimate ill that both offices agree needs to be eradicated: a breakdown in corporate governance. Sadly, it has become clear in a number of our investigations that certain mutual fund board members simply do not understand or do not care about their responsibilities to investors. That is why, in addition to restitution to investors and a fee reduction, the recent settlement with Bank of America provides for the replacement within one year of many of the Nations' Funds board members. This might seem like a drastic measure, but I believe it was clearly warranted, and we will use the remedy whereever the evidence so warrants.

Much work remains to be done in the areas of corporate governance and mutual fund reform. But working together, the SEC and my office have made significant progress and – as I indicated earlier –

succeeded in returning a large amount of money to damaged investors. I am confident that we will reach our goals, through a combination of SEC rulemaking, individual civil and criminal enforcement actions, and continuing SEC-state enforcement actions.

Again, I thank you for the opportunity to testify today, and I welcome any questions you might have.

Mr. PLATTS. Well, thank you, Mr. Attorney General. And, again, both the written testimony provided and your thoughts today are very helpful, which we appreciate.

A place I would like to start in the questioning is in laying out the three different chapters; the trading practices that were wrongful and that you have been a great leader in addressing both in the disclosure of those practices, which as you said, is in and of itself had a great impact and in your enforcement efforts and prosecutions in pursuing those wrongfully practices, but also the fee issue and the fiduciary duty or the lack of fulfillment of that duty to especially the small investors by some of the fund managers.

I am not sure if you will be able to hear the testimony of Mr. Bogle after you, but one of his recommendations that he has been promoting, I believe, from his testimony, for 8 years is kind of a comprehensive economic study of the mutual fund industry. He suggests that as part of the SEC's strategic plan and vision, that we really get an in-depth understanding of the industry and the fees associated, how the managers are actually conducting themselves, that's critical to going forward to effectively managing and overseeing and regulating this industry. And from your testimony it sounds like that is something you think would be a very wise approach for the SEC to embrace?

Mr. SPITZER. Absolutely. The SEC does have a division that is dedicated to oversight of the mutual fund sector. Having said that, I think it is critical that we step back and say what has happened in the sector, what returns are people actually garnering, how were those returns presented to the investing public, what the people know, what variables do they rely upon, what variables should they reply upon?

And let me make it perfectly clear, it is not government's job and never should be our job to make the investment decision for the individual investor. What we do have to make clear, however, what we do have to do is provide to the individual investor the tools so that he or she could make the individualized determination based upon full disclosure and the important variables that a wise investor would want to have at his or her fingertips to make those decisions.

Mr. PLATTS. Yes.

Mr. SPITZER. And all too frequently when you read a prospectus it is impossible to determine whether or not this is a good or bad investment because the fee structure is not there, the informant's numbers are not given in a format that is meaningful.

You know, I have analogized to the disclosure on the side of any food item when you go to the supermarket. You know, you could look at a little grid and it tells how much fat, what——

Mr. PLATTS. I try not read those, because you know they make me feel like I am eating too unhealthy.

Mr. SPITZER. Well, I am with you. I read them all too often after my kids have already eaten them.

Mr. PLATTS. Exactly.

Mr. SPITZER. You get 800 percent of your daily allotment of sugar when you have one bite of the cereal. But if we were to have that sort of disclosure with respect to fees on a monthly statement or quarterly statement, however often they come, the impact on fees

over the past 10 years or the next 3 years of the fee structures depending upon certain rates of return or the actual return, or a hypothetical $1,000 investment, how that investment would have fared over the last 10 years based upon the actual return, its return net of fees. There is so many ways to present this in a way that would be more meaningful to investors. And I think Mr. Bogle's idea of studying the industry to understand these factors and then come up with a way to present it to the public is critically important.

Mr. PLATTS. And I do appreciate your analogy to that label on the food box. And as a parent of a 5 year old and a 7 year old, they want that high sugar just as I did when I was their age. But a good analogy; more transparency, more knowledge for investors to make their decisions on.

You know, our focus for our subcommittee is the management efforts of the SEC. And whatever the rules are, the regulations, the law, how are they meeting the charge that they have with their resources, and especially their human capital resources.

In the three areas, again, the three chapters, which is I think a good way of looking at the mutual fund issue, what is your view on the SEC's response from that resource allocation aspect? They have done a good job on the trading practices and the regs they've proposed and have been more aggressive since your efforts since last September, but not as aggressive, and you agree to disagree I guess is your statement on the fees—on the three chapters. How would you——

Mr. SPITZER. It goes without saying, and Mr. Chairman I am trying very hard these days not to gratuitously scratch at a wound or at a relationship that has had ups and downs, obviously. But certainly the SEC is doing everything it can do these days to address these issues and we are probably going to be working together. So I just want that a predicate to anything I say.

Mr. PLATTS. Yes.

Mr. SPITZER. And Steve Cutler, who is Chief of Enforcement, is someone I speak to on a regular basis so we are on the same page in what we are doing. As Chairman Donaldson and I would also speak on a regular basis. So I do not want this to be interrupted or have gratuitous criticism.

I think the SEC has done a better job with respect to the trading abuses than it has done with respect to fees. I think that there is a bit of schizophrenia at the SEC with respect to the fee issue because it has been hesitant, as I said, to get involved in what it thinks should be a market determination with respect to fees. And we all agree, it should be a market determination. However, the market will determine fees properly only if the participants in that negotiation are sufficiently and properly aggressive in playing the role it's supposed to play. And hence, my discomfort at not pushing toward what's supposedly the voice for the small investors more aggressively in saying to them you must act in a particular way, get competitive data, ask the management companies what the comparative fee structure is for other types of investors, determine what the profit margins and revenue have been for the management companies. In other words, amass the very information that you would amiss if you were in a traditional negotiating contract.

The ICI did a report several months ago now, I think it was December of last year, in which it tried to rebut my allegation that fees that were being garnered for an individual investor were higher than fees that were being garnered for institutional investors. And they rolled this out and they said, ha,ha, see there is only 3 basis point differential, they figured 18 to 21 basis points in those two pools of money.

I said wait a minute, you have proven my point. Not because it is a 3 basis point differential, but because the comparison they did, and my recollection as I do not have it in front of, 18 basis points for institutional investors at fees, 21 basis points for individual investors when they had a subadvisor that had competed to get the advisory services for the individual investor. For subadvisors is the wrong comparison. That itself is only a small piece of the mutual fund pool of money. And it is the only piece of it where there is actual competition.

If you were to compare the institutional 18 basic points to the probably 30, 40 basic points that is being charged elsewhere in the industry, then you have that enormous gap that is generating what I spoke of earlier, which is the tens of billions of dollars that is improperly flowing to the mutual funds from companies which, in my view, they are not properly getting their hands on.

Mr. PLATTS. In kind of following along with allocation, whether it be not on the fee setting but on how fees are disclosed and, again, the allocation of the resources, you touched a lot on the important fiduciary duty to that typical Joe on the street, you know that smaller investor, and that they especially need that. And as your fee issue highlights, the need for involvement of the SEC.

In your opinion, especially in light of the SEC's request for a significant funding increase regarding the regulation of hedge funds versus mutual funds, is that something that we should be worried about that it is again focusing too disproportionate an amount of their resources on a select few of large investors as opposed to the 90 plus million small investors?

Mr. SPITZER. This goes back to my very opening comment about breach of the fiduciary duties being my primary concern. I am a little skeptical of the effort to focus so much attention on hedge funds right now, and let me be very clear. There are clearly hedge funds that abuse trading practices and trade in a way that is violate to the law. They have a poor position, they disseminate false research, they play market manipulation cases that should and will be prosecuted when they exist. However, hedge funds are designed to be nimble capital that moves quickly through the market, and that's what the law has always contemplated. Hedge fund managers are doing what they are supposed to do for their investors who are sophisticated investors and defined so statutorily through regulations. And, therefore, I am a little less worried about hedge funds abusing their relationship to their investors and when hedge funds individually act improperly in the market place, hopefully they'll be caught. So I do not think the notion of regulating hedge funds as a general area should be getting quite as much attention as it has been.

I am more focused on the theoretical and actual breach of fiduciary duties we have seen toward mutual funds and their small in-

vestors the 90 million investors you are talking about. That is where there is an issue of your concern that I think we should be focusing on.

In terms of resources, let me say this and again I do not say this to be gratuitously sharp with respect to the SEC. As important as resources are, I think that it is case selection that is more important. Cases have to be brought based on a strategic determination that they will have an impact in the marketplace. One case on market timing for late trading can be brought, as it opens an entire arena of impropriety and you then can solve a problem. And not to pat ourselves on the back, but everything we have done in the last 20 years is with about 15 lawyers total, which is a tiny percent of what the SEC has. And I do not say that to say look how good we are. Not at all. But I think it is case selection and making triage decisions that will lead you to the cases that will reveal structural problems that is most important.

Mr. PLATTS. I would like to yield to the ranking member, Mr. Towns.

Mr. TOWNS. Thank you.

Let me just pick up on that point. You have been able to do all this with 15 lawyers. Are you saying then that it is the mind set of the SEC is the reason why they have not been able to do even more with the limited resources?

Mr. SPITZER. Let me, Congressman, let me turn this and state it affirmatively.

Mr. TOWNS. OK.

Mr. SPITZER. Just so it is not to sort of re-inflame our relationship.

I think that recently we have seen a much more properly, a much more aggressive attitude on the part of the SEC with respect to examining structural issues that deserve to be examined. I think what the SEC is now doing, and very wisely so, is stepping back from the marketplace and asking itself where have there been shifts and new dynamics that have emerged such as with research so that you want to say wait a minute, is research being disseminated because it is believed in or because research is being used as bait for investment banking clients, and if it is the latter how do you need to respond in a regulatory level. So the SEC is beginning to ask the appropriate questions that will bring to the fore the cases that should be brought.

Mr. TOWNS. All right. Thank you.

You talked about in terms of fiduciary responsibility and, of course, protecting the small investors. And you said that it might require a legislative response. Do you have any specific ideas, some things that we might be able to do legislatively to boost this?

Mr. SPITZER. Well, I will bootstrap on Mr. Bogle's idea, which again he has been pushing for quite a while, which has very legislatively defined the fiduciary obligation that is owed by a mutual fund or to the small investor. I mean, that is something that should be done, I think.

You will hear, no doubt, from the industry, so you have already heard it or you will get submissions from them in which they claim well the fiduciary duty has been a little ambiguous and there have been some case law that makes it unclear what it is. Fortunately

here in New York I think we can make the case that we have the State law that is pretty good and we can use that, and have been using that. But I think the notation that there is just a very rigorous fiduciary obligation explosion has been—unambiguous fiduciary obligation explosion is something that should be enshrined statutorily. And Mr. Bogle has been pushing that notion for a while, and I think he's right.

Mr. TOWNS. You are very sensitive to the comment about the relationship between the SEC and your office, and I understand that.

Mr. SPITZER. Yes.

Mr. TOWNS. You do not want to distort at all, you are trying to help, and I understand that. And I recognize that. But have they discussed a strategic plan with you at all?

Mr. SPITZER. Oh, sure. Well, they did not discuss the particulars of stepping back and looking at the mutual fund industry, as has been suggested. But let me make it clear, I speak to Steve Cutler on a regular basis, the lawyers in my office speak to the lawyers in the Enforcement Bureau on a regular basis. We are reviewing the entire litany of enforcement actions that are pending. How we could think about these cases. I speak to Chairman Donaldson about these issues.

Yes, there is appropriate integration of thinking and discussion at this point. And that is progress. That has not always been the case, but perhaps there was not always the need for that to be the case. But certainly now we are working well together and are discussing these issues as they surface.

And let me make another point. It is important not only in terms of getting the maximum utility from the enforcement dollars that are allocated by Congress to the SEC and by the State to my office and other States to their enforcement entities, but also to prevent the risk of incoherence or inconsistency. And one of the things that I noticed in a topic of discussion on Capitol Hill, and rightly so, is the need for coherence and the need for eliminating any chance involved in evasion of enforcement that would lead to the incongruities of how we interpret the law and how we enforce it so that this effort to speak with the SEC and work together is driven by both of those motivations.

Mr. TOWNS. Right. Let me ask this, I want to deal with the SEC. I think that if there is anything that you feel we need to do through Congress to make—I guess more in terms of reassuring people, you know, and I think that the integrity is there. And I think that is something that we have to be concerned about, you know, as we move forward is the integrity. And what can we do in the Congress to come up with rules and regulations and legislation in particular that might give people that reassurance?

Mr. SPITZER. Here is what I would say, and I have absolutely no reason to think or suspect when you use the word "integrity," that it is inferred a failure of integrity in terms of somebody intentionally overlooking an issue. So I want to put that aside.

I think that something that Congress, and perhaps this subcommittee could wisely spend a bit of time on would be an examination of what—and I don't say this with any disrespect to Paul Royce who is the head of the Legal Fund Division of the SEC, but examination of what that division had besides for 2 or 3 years ago

set as its regulatory priorities. In other words, it would be a fair question what were you examining when in your oversight capacity with respect to the mutual funds, I mean had you foreseen this. Of course, with the 9/11 Commission sometimes, you know, retrospective examinations can get a little partisan but I think in a moment of quiet it would be useful to say were you looking at the issue of fees, were you looking at the issue of fiduciary obligations and how those would be fulfilled. Did you have any evidence that there were issues related to timing and late trading, and if so what was done with respect to that effort. And I think it would be a good case study of regulatory, what we now can say I think would be regulatory failure. And it would be a useful exercise to go through again, not in an effort that sort of points fingers and says ahah, I caught you. But I think there will be lessons there that could guide us prospectively so that 10 years from now we do not say in other sectors that, gee, we should have thought of that.

Mr. TOWNS. Right. You testified before the House Financial Services Committee that there must be fundamental change in the mind set at the SEC.

Mr. SPITZER. Right.

Mr. TOWNS. So I guess you now feel that change has started taking place?

Mr. SPITZER. Well, I am trying to be kinder and gentler but it certainly—yes. It certainly happened. And I did say that, and as I said I have been pretty critical of the SEC at different points in time, and I am not going to take back any of those words.

Mr. TOWNS. No.

Mr. SPITZER. But I think that there has been a real change in that perspective in an effort to really rachet up or down in perspective the degree of intensity of examination, and that is very much to the SEC's credit. I think it was needed. And I think that there was certain complacency, perhaps, several years back when the markets were booming, people were happy. Those things happen. And so I think that is, however, perhaps when one needs to be most diligent and attentive. And I think now we have turned that corner and I think that is good for the investor.

Mr. TOWNS. I yield to the chairman.

Thank you.

Mr. PLATTS. Thanks, Mr. Towns.

I think that is an important point in that is that just because the market is booming and numbers are going in the direction you want, does not mean that there are no problems out there. Because the market was doing so well we were not looking maybe as close as we should have been at some of these issues. And I appreciate that you are seeking to be kinder and gentler today than maybe in the past.

And the followup, and it is not to point fingers but to get a true understanding, and one of the things that you bring is an outside perspective, you know, at the State level and in the Attorney General's office versus the regulatory side. Once you got into the issue, the mutual fund issue, was it just not enough resources being put into this area by the SEC that they were not catching these trading practices?

Mr. SPITZER. I think that there was perhaps too great a willingness to accept sometimes what was being said by the industry. I mean, you think about the mutual fund industry, I have said repeatedly that my office found abuses not because we are so smart, and I think we are but I really do not think we are any better or any smarter or any more diligent than anybody else. It is just that we saw what should have been obvious to everybody because it was known by everybody on the street. That was the case of fraud research. It was the case of fees that were too high. The late trading perhaps was a little more subtle. But the timing, I will tell you, there were hedge fund prospectuses that were floating around there, anybody who had seen them, and certainly the SEC and others had seen them, you knew that there were billions of dollars that had been raised and allocated by hedge funds to the timing of mutual funds.

Now, as I have said, there is nothing wrong, illegal on the hedge fund side of that equation if you can do it depending upon where you are on the mutual fund side. But certainly if you were a mutual fund regulator and you were aware that there is this new pool of money sloshing around the mutual fund world dedicated to timing of funds, you would want somebody to say where is it going, how does that effect. Everybody knew that had a negative impact on the individual investor. So certainly I think some of those questions should have been asked. And the mutual fund industry has maintained for years and gotten away with that, and they say every year they will cure.

And so I think there has been an acceptance of that without a sufficiently inquisitive challenge to some of these practices.

Mr. PLATTS. With the strategic plan that we are pushing and looking forward to hopefully here in the near future, to see from the SEC, our committee when we had a hearing last summer and we talked about strategic plan, we think it is critical if we are going to talk about a 12 percent funding increase for one segment of the enforcement regulatory efforts, that if you do not have the big picture what are you taking those funds from and is it mutual funds, is it other important priorities? And in getting to that point that we have a strategic plan, if I understood your answer to Mr. Towns' question you have a regular dialog with the SEC and your staff do, but there has been no specific request for your input on this strategic plan and their focus to the allocation of manpower and resources regarding enforcement?

Mr. SPITZER. No, no. There has not been. And, frankly, I would not expect them to ask my perspective on that. You know, I would not ask them to tell me how to allocate the budget within my organization. I would not expect them to say, hey what do you think.

Mr. PLATTS. I think that's kinder, as you say. But I also think it is relevant in the fact that you have mentioned you have 15 attorneys, and the success and efforts you have undertaken and important efforts for those typical investors out there, given the size of the SEC and that you are obviously being fairly efficient with your resources and your allocations and prioritization. And that is something we will get into with the SEC as far as who are they asking for feedback from regarding their strategic plan.

In your approach I assume that technology is an important part of your efforts to maximize your manpower. Do you use data mining and that type practice or is it more manpower?

Mr. SPITZER. Yes. But I would say that the cases—and I wish I could tell you otherwise, but the cases do not emerge from data runs that lead us to irregularities for trading patterns that we then say we have to look at this. Part of it is that we do not have that capacity nor the data at our fingertips.

We certainly use enormous data runs once we have a theory that we either begin with, just somebody creates it or somebody brings it to us. We then test that theory. And one minor example of that is, perhaps, in our efforts to calculate dilution effects from the impact of timing of mutual funds, we do enormous quantitative analyses and you have spectacular economists at my office who is involved in running these numbers and comes up with models to figure out how we could quantify. So we do not do it data in theory, we do it theory can we turn it into and try to do that.

Mr. PLATTS. Right.

Mr. Towns, did you have other questions.

Mr. TOWNS. No. Thank you very much, Mr. Chairman. I would like to thank the Attorney General for coming and the work that he is doing in this area. He has 15 lawyers, I mean you would have to be impressed with that.

Mr. SPITZER. I think they are very good lawyers.

Mr. TOWNS. Evidently so. Thank you so much.

Mr. SPITZER. Thank you.

Mr. PLATTS. OK. And I would like to add my thanks again for your time today and the great efforts of you and your staff in doing right by that typical investor out there. We appreciate your work, and wish you well.

Mr. SPITZER. Thank you very much, Mr. Chairman.

Mr. PLATTS. Thank you.

Mr. SPITZER. Thank you.

Mr. PLATTS. We will take a quick 2 minute break as we get our second panel with Mr. Bogle and Dr. Morey and reconvene here shortly.

[Recess].

Mr. PLATTS. We are ready to reconvene this hearing.

Thank you, Mr. Bogle and Mr. Morey for your statements. Will your raise your right hands and answer the following?

[Witnesses sworn].

Mr. Bogle, we will hear your testimony first.

STATEMENT OF JOHN BOGLE, BOGLE FINANCIAL MARKETS RESEARCH CENTER, FOUNDER VANGUARD MUTUAL FUNDS

Mr. BOGLE. Thank you for inviting me to speak with you today. I hope that my experience in the mutual fund industry will be helpful in considering the issues before you regarding resource allocation and strategic planning at the Securities and Exchange Commission.

I have been involved in this business since I began to write my Princeton senior thesis which I began in 1949. In 1951, I went to work for industry pioneer Wellington Management Co., and ran that company from 1965 to 1974. In 1974, after being fired from

Wellington Management Co., I founded a new mutual fund organization, called the Vanguard Group of Investment Companies. Vanguard, surprisingly enough, represented my attempt to create a firm that would measure up to the goals I set forth for the fund industry in my Princeton senior thesis, all those years ago:

No. 1: To place the interests of fund shareholders as the highest priority; No. 2: To reduce management fees and sales charges; No. 3: To make no claim to performance superiority over the stock market indexes; No. 4: To manage mutual funds, "in the most honest, efficient, and economical way possible."

These goals, of course, were clearly aligned, not only with what I regarded as the "spirit" of the Investment Company Act, but with its "letter": to insure that mutual funds are "organized, operated, and managed" in the interest of shareowners, rather than in the interest of managers and distributors.

We've done our best at Vanguard, to achieve those goals, and we are now the lowest cost provider of mutual funds in the world. And we are also one of the two largest firms.

After relinquishing my position as Vanguard's senior chairman in 1999, I have been engaged in researching, writing, and speaking about investing in the mutual fund industry. I have also written a half-dozen op-ed pieces for the New York Times and the Wall Street Journal, and four books, all with strong views about this industry's need to better serve its shareholders. But I am sorry to tell you gentlemen, the fund industry has yet to measure up to those idealistic, yet wholly realistic, goals I urged upon it way back in 1951.

Disgusting as they are to someone like me who has made fund management his life's work, the recent market timing scandals have a good side. They call attention to the profound conflicts of interest that exist between mutual fund managers and mutual fund shareholders, conflicts that arise from an inherently flawed governance structure in which fund owners, in practice, have very little if any voice. The trading scandals are but the small tip of a very large iceberg, with the cost of time zone trading estimated to be $5 billion a year. By contrast, in 2003 alone, the total cost of managing the industry's $7 trillion of assets came to more than $100 billion counting turnover costs. An amount that is, of course, largely if not entirely responsible for the shortfall that mutual funds demonstrate in being able to keep with the returns on the markets themselves. If the management portion of those costs were subject to arms-length negotiation, tens of billions of dollars would be saved year after year after year.

The same kind of stewardship that demands that fund directors effectively represent the shareholders who elect them and to whom they are responsible under the law is rarely found in this industry. Rather, managers have focused not on salesmanship but on salesmanship. Their agenda is inarguably dominated by the desire to bring in assets under management. That marketing agenda led us to create 496 new "new economy" funds during the stock market bubble, not because they were prudent investments, but simply because we saw that the public was eager to buy them. And in the ensuing market crash, these very funds cost the public quite literally hundreds of billions of dollars. The conflicts of interest that

engendered these unhappy and costly outcomes for fund shareholders must be resolved in favor of fund owners, not fund managers. And the recent scandals give us the opportunity to at last build a fund industry that is worthy of its early heritage, one that does what I have long—sometimes, I think forever suggested: To give this industry's 95 million investors a fair shake.

Achieving this goal, make no mistake about it, must come from the industry itself, from within the industry and from investors. But it cannot be accomplished without an active, energetic, dedicated, fully staffed Securities and Exchange Commission. During my long career, both before and after the market bubble and the corporate and mutual fund scandals, I have had frequent occasions to work with members of the Commission and its staff. And it is absolutely without hesitation that I report to you on the subcommittee that, virtually without exception, I have found these individuals to measure up to the very highest possible standards of public service, integrity, expertise, education, intellectual curiosity, and willingness to listen and make reasoned decisions. And I would like to take this opportunity to salute the Commission and its staff.

The scope of their oversight of tens of thousands of corporations, and exchanges, and accounting firms, broker-dealers, advisers, mutual funds is enormous. And as these activities exploded during the bubble, the Commission's workload soared accordingly. So, as you know, did the SEC fees paid by these entities, from $750 million in 1996 to $2.3 billion three or four times as much—in 2000. If only those fees had flowed directly to the Commission, it might have had a fighting chance to hire and retain and motivate a staff sufficient in number and talent not only to deal with that cascading flow of paperwork, but to increase its investigation and overview and probe much more deeply into the emerging issues of the era. However, the SEC fees collected do not represent the funds appropriated for SEC operations, as you and the Congress know. In fact, the Commission's appropriation for 2000 was just $370, 16 percent, one-sixth, of the SEC fees paid. It is hard to imagine that the Commission would not have been far more able to handle the added regulatory responsibilities engendered by the bubble had its funding grown apace with its responsibilities. I'm pleased they are finally starting to get much more funding. For a Commission starved in resources and plagued by high staff turnover, is a Commission unable to fulfill its mission of overseeing our Nation's vital system of financial markets. That said, I do not want to appear to excuse, solely on the basis of limited resources, the Commission's failures in its oversight of issues, markets, and funds. Economics, after all, is all about the allocation of limited resources in a world where needs are always unlimited. Neither private enterprise nor public agency ever succeeds in getting its resource allocation exactly right. And if I may say so, I can assure you that in running two different mutual fund management companies, I certainly never got the resource allocation exactly right. But I think we have to acknowledge our mistakes, as I try and do, learn from them, as the SEC is doing, and use that wisdom to do a better job in the future.

I believe the Commission is doing that. I am impressed, and always have been, with the leaders of both the Division of Enforcement and the Division of Investment Management as they respond

to the clear evidence that we've been discussing today, illegal behavior among firms that were once considered industry leaders.

I am also impressed with Chairman Donaldson's willingness to tackle how the Commission operates, and particularly his new Office of Risk Assessment and Strategic Planning which is positively responsive, of course, to the subject of your hearing today.

As I am most familiar with the Commission's Division of Investment Management, my written testimony lists 7 issues that either need additional attention or should be upon the SEC's planning agenda. I will not go through them.

In the time available to me, just let me say a couple of works about each.

No. 1: Mutual fund market timing. You should know, as my testimony points out, it has been going on for at least a decade and we all knew it.

No. 2: Hedge funds. They have played a major role in the mutual fund scandals, as Attorney General Spitzer mentioned. An article that was published in the Financial Analysts Journal in 2002 identified 30 hedge funds that were doing this and nobody did anything. So for these reasons and others, I do endorse Chairman Donaldson's view that hedge funds must—must—be drawn under the Commission's purview.

No. 3: Compensation of portfolio management disclosure. Right now we have proposed rules that would describe how portfolio managers are compensated, but not how much they are compensated. That is notably the same as no disclosure at all. I believe we need disclosure of the dollar amount of compensation not only of portfolio managers, but of the five highest paid executives of the company. Why should the mutual fund industry be exempt from the disclosure required of other corporate executives.

No. 4: Fees paid by pension accounts that are managed by fund managers. Why are the fees funds pay often from 100 to 150 times as large, as for example, the fees that California's personal retirement plan, (CALPERS), pays those same managers, presumably the same portfolio of essentially the same securities.

No. 5: 401-k plans. Recent press reports have detailed clandestine payments from fund managers to pension clients, often in the form of rebates. The SEC investigation of this area simply has to be a high priority.

No. 6: The role of financial conglomerates is almost never discussed. When I came into this business, fund management companies were privately owned organizations owned largely by the fund managers themselves. Today public ownership and ownership by giant financial conglomerates have gradually become the industry's modus operandi. Of the 50 largest fund management groups, 36 are owned by huge financial conglomerates.

Why do conglomerates buy mutual fund management companies? They do it to earn a return on their capital, the conglomerate's capital. Yet the 1940 Act makes earning a return on the fund's shareholder's capital the overriding priority. This rarely acknowledged conflict of interest cries out for study.

No. 7: Yes, an economic study of the mutual fund industry.

A few minutes ago, Attorney General Spitzer mentioned the need for an economic study.

Now to conclude just very briefly having laid out the litany of priorities of a strategic study by an SEC whose resources are already stretched, I fully recognize the job before the Commission is large and its resources, while large are still limited. These tasks, however, are not only worthwhile, but essential for the protection of investors. However, I want to offer now a final recommendation in more detail in my written testimony that could in the long run actually reduce the Commission's regulatory responsibility. Just think about this: One of the principle reasons for existing regulation and the existing additional regulation, and the areas of study I've noted above, is the need to deal with the profound and obvious conflict of interest that exists between mutual funds and their shareholders on the one hand and management companies and their shareholders on the other. The timing and trading scandals, the setting of appropriate fees, the focus on asset gathering are all issues that reflect this conflict, and the costs they impose are deducted from returns of the financial markets, and trickle down, if you will, to fund shareholders. Those things must be addressed.

The Investment Company Act of 1940, our Constitution, the law of the land, puts the fund in the driver seat and the management company in the rumble seat. A narrow reading of the act would not even allow the management company into the car. Read the act and see if you don't agree with me. The fact is, however, that it is the management company that's driving the darn car. If funds were truly organized, operated and managed solely in the interest of fund shareholders, most of today's regulatory problems would vanish. The funds would protect their own shareholders. That is what they are supposed to do. How to get to that goal is a good question for the highest use of SEC's strategic resources.

That concludes my testimony. And I thank you for your attention.

[The prepared statement of Mr. Bogle follows:]

Statement of John C. Bogle

Before the Subcommittee on Government Efficiency and Financial Management U.S. House of Representatives New York, NY April 20, 2004

"Resource Allocation and Strategic Planning at the Securities and Exchange Commission"

Good morning, Chairman Platts, Ranking Member Towns, and sub-committee members.

Thank you for inviting me to speak with you today. I hope that my experience in the mutual fund industry will be helpful in considering the issues before you regarding resource allocation and strategic planning at the Securities and Exchange Commission.

I have been involved with the mutual fund industry ever since I began to write my senior thesis at Princeton University in 1949. In 1951, I went to work for industry pioneer Wellington Management Company, heading the company from 1965 to 1974. In 1974, I founded a new mutual fund organization, which I named The Vanguard Group of Investment Companies.

Vanguard represented my attempt to create a firm that would measure up to the goals I set forth for the fund industry in my thesis, all those years ago:

- To place the interests of fund shareholders as the highest priority;
- To reduce management fees and sales charges;
- To make no claim to performance superiority over the stock market indexes;
- And to manage mutual funds, "in the most honest, efficient, and economical way possible."

These goals proved to be closely aligned, not only with what I regarded as the *spirit* of the Investment Company Act of 1940, but with its *letter*: to insure that mutual funds are "organized, operated, and managed" in the interest of shareowners, rather than of managers and distributors. We've done our best to achieve those goals, and today Vanguard is both the world's lowest-cost provider of financial services and, with some $730 billion of assets under management, one of its two largest mutual fund firms.

Since relinquishing my position as Vanguard's senior chairman in 1999, I have been engaged in researching, writing, and speaking about investing and the mutual fund industry. I have also written a half-dozen op-ed pieces for *The New York Times* and *The Wall Street Journal* on these matters, as well as several additional books, all presenting strong views of this industry's need to better serve its shareholders. But I am sorry to tell you that the fund industry has yet to measure up to the idealistic, yet wholly realistic, goals I urged upon it way back in 1951, indeed the goals so clearly articulated in the 1940 Act.

Disgusting as they are to someone like me who has made fund management his life's work, the recent market timing scandals have a good side. They call attention to the profound conflicts of interest that exist between mutual fund *managers* and mutual fund *shareholders*—conflicts that arise from an inherently flawed governance structure in which fund owners, in practice, have little voice.

The trading scandals are but the small tip of a very large iceberg of conflicts. One academic estimate of the cost of international time-zone trading came to $5 billion per year. By contrast, in 2003 alone, the total cost of managing the industry's $7.0 trillion of assets in stock, bond, and money market funds may have come to more than the $100 billion, a cost that is largely—indeed, almost entirely—responsible for the shortfall of mutual fund returns to the returns available in those markets themselves. If the management fees that represent the major portion of those costs were subject to arms-length negotiation between the funds and their managers, tens of billions of dollars could be saved and added to investor returns, year after year.

The kind of *stewardship* that demands that fund directors effectively represent the shareholders who elect them and to whom they are responsible under the law is rarely found in this industry. Rather, managers have focused on *salesmanship*, their agendas dominated by the desire to bring in assets under management. That marketing agenda led us to create hundreds of

risky "new economy" funds during the stock market bubble, not because they were prudent investments, but simply because we saw that the public was eager to buy them. In the ensuing market crash, these very funds cost their shareholders hundreds of billions of dollars.

The conflicts of interest that engendered these unhappy and costly outcomes for fund shareholders must be resolved in favor of fund *owners*, not *fund managers*. The recent scandals give us the opportunity to at last build a fund industry that is worthy of its early heritage, one that does what I have long—sometimes, I think, *forever*—suggested: Give this industry's 95 million investors a *fair shake*.

The Role of the SEC

Achieving this goal, finally, must come from the industry itself. But it cannot be accomplished without an active, energetic, dedicated, fully staffed Securities and Exchange Commission. During my long career, both before and after the market bubble and the corporate and mutual fund scandals, I have had frequent occasion to work with members of the Commission and its staff. It is without hesitation that I report to the Subcommittee that, virtually without exception, I have found these individuals to measure up to the highest standards of public service—integrity, expertise, education, intellectual curiosity, and willingness to listen and make reasoned decisions. I salute them.

The Commission's oversight and examinations cover tens of thousands of corporations, exchanges, accounting firms, broker-dealers, investment advisers, and mutual funds. As the activities in each of those fields exploded in a frenzy during the late market bubble, the Commission's workload soared accordingly. So did the SEC fees paid by these entities, from \$750 million in 1996 to \$1.8 billion in 1998 to \$2.3 billion in 2000.[1]

Had those fees flowed directly to the Commission, it might have had a fighting chance to hire, retain, and motivate a staff sufficient in number and talent not only to deal with the cascading flow of paperwork from new offerings of securities, new and complex financial instruments, and new mutual funds, but to increase its investigation, overview and probe more deeply into the emerging issues of the era. However, the SEC fees *collected* each year do not represent the funds actually *appropriated* for SEC operations. In fact, the Commission's

[1] All figures are approximate.

appropriation was just $300 million in 1996 (only 40% of the fees), $315 million in 1998 (20% of the fees), and $370 million in 2000 (16%).

It is hard to imagine that the Commission would not have been far more able to handle the added regulatory responsibilities engendered by the bubble had its funding grown apace with its responsibilities. But even in 2003 (when SEC fees had fallen to $1 billion), it was appropriated only $600 million in funding. I am pleased that a substantial increase in funding lies ahead, for a Commission starved in resources and plagued by huge staff turnover is a Commission unable to fulfill its mission of overseeing our nation's vital system of financial markets.

That said, I do not want to appear to excuse, solely on the basis of limited resources, the Commission's failures in its oversight of issues, markets, and funds. Economics, after all, is about the allocation of limited resources in a world where need is essentially unlimited. Neither private enterprise nor public agency ever succeeds in getting its resource allocation precisely right. (I can assure you that in running two different fund management companies, I certainly didn't!) But we must acknowledge our mistakes, learn from them, and use that wisdom to do a better job in the future.

My sense is that the Commission has done, and is doing, exactly that. I am impressed with the leaders of both the Division of Enforcement and the Division of Investment Management as they respond to the clear evidence of unethical, and in some cases illegal, behavior that have been uncovered among a score of mutual fund managers, including some once considered industry leaders. I am also impressed with Chairman Donaldson's vigorous leadership in reforming how the Commission operates, as outlined in his testimony to the Senate Committee on Banking, Housing, and Urban Affairs on April 8, 2004. His initiation of a new Office of Risk Assessment and Strategic Planning is directly and positively responsive, of course, to the subject of your hearing today.

As I am most familiar with the Commission's Division of Investment Management, I will take the liberty of commenting on a few of the issues that are receiving attention today, and some that seem to have received, for whatever reason, inadequate attention in the past:

1. **Mutual Fund Market Timing**. The so-called "time-zone" trading in international funds has been going on for at least a decade, although it seemed to accelerate in recent years. Most industry participants were aware of it, and its frequency could be easily measured, or at least suggested, by the daily purchases and liquidations in each fund's shares; these data, indeed, are published in each fund's annual and semi-annual reports. In funds where the most frequent timing was going on, shares purchased and redeemed each year were three or four *times*—or more—the fund's total assets. In some cases, the sources of these flows were difficult to detect, but far too few fund managers seemed willing to stem the tide by such obvious means as stiff redemption fees, mandatory holding periods, or "fair-value" pricing.

2. **Hedge Funds**. The activity of hedge funds in this illicit market timing activity also was hardly a secret. Indeed, an article by four New York University professors, published in *The Financial Analysts Journal*[2] in 2002, noted that there were thirty hedge funds that identified "mutual fund market timing" as their investment strategy. The article not only described how to implement timing maneuvers and the returns achieved by timers, but also bluntly pointed out that such schemes worked against the interests of the other shareholders in the funds and urged fund managers to take corrective action. (For this and other reasons, I share Chairman Donaldson's view that hedge funds must be brought under the Commission's purview.)

3. **Portfolio Manager Disclosure**. Having full and fair disclosure has been—and should always be—the hallmark of our system of financial regulation. But we should not forget that the reason disclosure works is only in part that it informs the investing public. Even more important, in my view, is that *disclosure modifies behavior*. In essence, if an action has to be disclosed, we'll think twice before we do something questionable. I would hope the Commission would dedicate some resources to the issue of disclosing the compensation of mutual fund executives, often veiled by the fact that they are employed by a management company that is either privately-held or part of a financial conglomerate. The Commission is now considering a proposed rule that would require, among other things, disclosure of *how* (but *not how much*) portfolio managers are compensated. It must be obvious that such a limited disclosure is essentially *no*

[2] "Stale Prices and Strategies for Trading Mutual Funds," July/August 2002, by Jacob Boudoukh, Matthew Richardson, Marti Subrahmanyam, and Robert F. Whitelaw.

disclosure. The Commission should require disclosure of the *dollar amount of each manager's compensation* (including his or her share of the profits of the management company itself). Comparable disclosure should also be required for the five highest-paid executives of the company. There is no rational reason for exempting fund executives from the spotlight of public disclosure applicable to their counterparts in regular corporations.

4. **Pension Accounts Managed By Fund Managers.** Among the 100 largest fund managers, 13 are state and local pension funds. Of the 87 private managers, fully 77 manage *both* mutual funds *and* pension funds. This issue is worthy of Commission focus for two reasons: First, to understand how fund managers handle potential conflicts between the two classes of clients, such as allocations of portfolio transactions and new issues. Second, and even more important, to assess the reasons for the wide disparity in fees paid by pension fund and mutual fund clients. The California Public Employees' Retirement System, for example, often pays advisory fees of a mere *one-hundredth* of the fees paid by the mutual fund controlled by the adviser, both portfolios presumably owning similar portfolio securities. Calpers typically demands, and receives, low base-fee rates, with incentive fees for superior returns, but the adviser doesn't agree to similar arrangements with its mutual fund. There may be reasons for the differences, but the Commission—to say nothing of the fund's board of directors—ought to understand them.

5. **401-k Plans**. Recent press reports have reported clandestine payments from fund mangers to pension clients, often in the form of rebates. The relationship between administrative costs paid by these plans, the costs assumed by the fund sponsor and their relationship to the advisory fees the assets generate, the amounts borne by the company, the amounts shifted to the plan participants, and the sources of compensation to pension consultants all deserve prompt and careful study. Most 401-k plan arrangements are unregulated, and guidelines for fair practice do not seem to exist. This area should be a high strategic priority.

6. **Conglomerates.** Until 1958, fund management companies were privately-held organizations, owned largely by the fund managers themselves. Then, despite Commission opposition, the Supreme Court held that such companies could go public. As a result, public ownership and ownership by fund conglomerates has gradually

become the industry's *modus operanti.* Of the 50 largest fund managers, only seven privately-held firms remain (including Vanguard, owned by our *fund* shareholders). Seven are publicly-held, and 36 are owned by large U.S. and foreign financial conglomerates, banks, brokerage firms, and insurance companies. These businesses purchase fund companies in order to earn a return on *their* capital; yet the 1940 Act makes earning a return *on the fund shareholder's* capital the over-riding priority. This rarely acknowledged conflict of interest cries out for study.

7. **An Economic Study of the Mutual Fund Industry**. While I have been calling for such a study for at least eight years, my voice has fallen on deaf ears. *Such a study must be an essential focus of the Commission's strategic planning efforts.* It would evaluate the role of mutual funds and their managers in the context of our national economy, and facilitate an understanding of how the fund industry actually works. We need, in short, to "follow the money"—to account for the sources of industry's direct revenues (administrative fees, distribution fees, sales loads, out-of-pocket fees, etc.), operating expenses paid by shareholders, and indirect revenues utilized by fund managers, including brokerage commissions. We also need to account for the uses of these revenues—for administration, for marketing and distribution, for investment management, and for other major cost centers (including soft dollars). Without this information, regulation must, in essence, operate in the dark—in an information vacuum. (Be clear, please, that I am *not* in favor of fee regulation.)

Having laid out this litany of priorities for strategic study by an SEC whose resources are already stretched, I fully recognize that the job before the Commission is large and its resources, while larger now, are limited. But these tasks are not only worthwhile, but essential, for the protection of investors. However, I would like to offer a final recommendation that could, in the long run, actually *reduce* the Commission's regulatory responsibilities. Just think about it: One of the principal reasons for existing regulations, the additional regulations now being considered, and the areas for study that I've noted above is the need to deal with the profound and obvious conflicts of interests that exist between mutual funds and *their* shareholders on the one hand, and management companies and *their* shareholders on the other. The timing and late trading scandals are obvious examples of this conflict. The setting of appropriate fees is an equally obvious conflict, and has an economic impact many times the magnitude of the scandals. And the fund

industry's focus on asset-gathering through huge sales and marketing expenses and new and exotic "products" clearly manifests another conflict of interest, also of huge dimension.

Yet, as I noted at the outset, the Investment Company Act of 1940 provides that *funds must be "organized, operated, and managed" in the interests of their shareholders, rather than their advisers and distributors.* Metaphorically speaking, the law of the land—our Constitution, if you will—puts the fund in the driver's seat and the management company in the rumble seat. (Indeed, a narrow reading of the Act would not even allow the management company in the *car*!) But the fact is—I think beyond argument—that it is the management company that is driving the car. If funds were truly organized, operated, and managed solely in the interest of their shareholders, many, indeed most, of today's regulatory issues would vanish. *The funds themselves would protect their shareholders*—with their own rules against market timing and late trading; with advisory fees that were set at arms-length and with failed managers not necessarily being replaced by managers from the same company; and with funds organized not merely because they can be sold, but with service to investors and prudent investment principles as their foundation.

How can we achieve, or at least approach, this goal? Now *there* is a good question for the use of SEC strategic resources! For an industry that operates, as the 1940 Act says, "in the national public interest and the interest of investors," public policy *must* move in the direction of an industry structure focused on the interests of its share owners, just as the existing law both intends and expresses.

How to begin?

1. A federal standard of fiduciary duty for fund directors.
2. An independent chairman of the fund board.
3. No more than a single affiliated director.
4. A staff (or consultants) to provide the fund with objective information with which to evaluate the management and marketing performance of the advisor, as well as the appropriate compensation for its services.

We need these long overdue reforms in fund governance, and *we need them now.* Some steps may require only Commission action; some (notably the fiduciary duty standard) doubtless would

require legislation. High on the Commission's list of strategic priorities and its allocation of resources should be the decision as to where regulation will suffice and where legislation is required, and it should be a vigorous proponent of such legislation.

These reforms are hardly a panacea that will bring the fund industry into compliance with the spirit of the 1940 Act. But "a journey of a thousand miles begins with a single step." Thank you for hearing me out.

Mr. PLATTS. Thank you, Mr. Bogle. And we'll save questions until we have Morey's statement and then have questions for both of you.

Dr. Morey.

STATEMENT OF MATTHEW R. MOREY, Ph.D., ASSOCIATE PROFESSOR OF FINANCE, LUBIN SCHOOL OF BUSINESS, PACE UNIVERSITY

Dr. MOREY. Thank you very much. I wanted to thank the Committee for inviting me here to attend the meeting and also to thank you for coming to Pace. It is wonderful when we get the opportunity to have you all here. And I hope you consider having other meetings here in the future.

With this testimony I wanted to give my thoughts on two particular issues concerning the regulations of the mutual fund industry.

First, I wanted to relate that the SEC recently has been making impressive strides to improve the institution's ability to regulate the fund industry; however I think more should be done given the increased importance of mutual funds in the United States.

And second, I believe that disclosure is the most important issue to focus on with regards to regulating the fund industry. And I wanted to sort of be up front and say that it is my belief that I think investors are in fact intelligent. If they are informed of the basic operations of mutual funds in a clear, concise and accurate way, investors can understand the differences between funds and I believe make better investment decisions. And I say this because I think many of the problems that we are talking about in the last couple of years and so on relating to the fund industry are associated with this lack of disclosure.

Now in terms of the SEC's role in regulating mutual funds, I believe that Chairman Donaldson is moving the regulatory institution in the right direction. The much needed, recent increases in the SEC's budget have allowed it to hire many more people, pay them more competitive salaries, and so on. And this, combined with the SEC's fresh interest in investigating many of the most important mutual fund abuses such as disclosure, fees and market timing, are all major improvements. However, I would encourage the committee to push for even more funding and support of the SEC with regards to the mutual fund industry.

Consider for a moment that the size of the SEC's budget, and now using what we're basically considering the SEC's budget for the future, the best SEC's budget has gone from $166 million in 1990 to a proposed $913 million for 2005. And this constitutes an increase of 5.5, 6 times, if you will. From 1990 to 2002, mutual fund asset—of course in 2002 they much lower at that time because the market had gone down—mutual funds assets have increased about six times during that time. So, on the surface, it does look like the funding now with the recent increases is keeping up with the growth of the industry. But if you look more deeply at mutual funds themselves, these figures do not illustrate the entire picture. For example, in 1990 only 6.7 percent of total financial assets held in U.S. households were in mutual funds, only 6.7 percent. Twelve years later at the end of 2002, the percentage was almost

18 percent, 17.8 percent to be exact. So almost a threefold increase. And hence, while the SEC funding may be close to matching the growth of the industry if you look at those numbers I was giving you before, it does not take into consideration the importance of this industry. It really has grown dramatically. And in fact, I can quote some studies that have basically found that the amount of money in mutual funds today is more than are in private U.S. banks. And it is a major financial institution that deserves to have some type of regulation that these other financial institutions have.

Furthermore, I would encourage the committee to push for more support of the SEC during the times that it needs it most: bull markets. Paradoxically, the very moments when the SEC needs the largest increases in funding are, I believe, when markets seem to be behaving well. It is during these times that many scandals arise as support for regulation declines considerably. Congress, like the SEC, must be farsighted enough to know that bull markets do not necessarily mean the fund industry is functioning well.

The second issue I wanted to talk about is disclosure. And this has been talked a lot about by our previous witnesses.

As I said before, I believe that many of the problems that we have in the fund industry today are associated with the lack of disclosure and that forcing the industry to be more up-front about fund practices would greatly help the industry in the future.

First, consider expenses or fees, which have been widely talked about already. As is well known, mutual funds do not clearly state or describe their expenses to investors. While the expense ratio does give information on the cost of running many of the aspects of the fund, brokerage fees are not included in this calculation. And what this means is it is difficult, if not impossible, for investors to discern the true expenses of a fund. Now this is vital information for the following reason: In almost all the academic research on mutual fund performance, the one consistent factor that is shown to be of help in terms of predicting future mutual fund performance is of the expenses. That is, low expense funds, on average, out-perform high expense funds. However, because not all expenses are disclosed to investors, they are left without the key information to help them invest wisely. If the SEC were to require full and complete disclosure of fees and expenses, it would greatly help investors in selecting funds and, I believe, it would help restore trust in mutual funds.

Second, another problem with mutual funds that is related to disclosure is window dressing. Until recently the SEC required funds to disclose their actual portfolio holdings only twice a year. And recent academic research—some of this by myself—however, indicates that since disclosure is so infrequent or has been so infrequent, some funds practice a behavior known as window dressing, whereby they cosmetically alter their portfolios right before disclosure in an effort to make the portfolio look better than it actually is.

For example, a bond fund manager may attempt to hold slightly higher quality bonds right at the time of disclosure in an effort to show a safer portfolio. However, immediately after disclosure, the manager dismantles these cosmetic positions. For investors, the detrimental effects of window dressing are two-fold.

First, investors can be misled about the sources of fund performance. Taken to the extreme, this deception could conceal investing behavior inconsistent with the fund prospectus.

Second, additional explicit transactions costs are borne by investors to build and dismantle cosmetic positions. It is my belief that window dressing can and probably will be mitigated with more regular disclosure. If funds have to disclose their holding more often, more frequently, say on a quarterly basis which is the new change that the SEC has implemented I believe last 2 months ago, it would be more difficult for a fund to hide what it is actually holding and more expensive to practice window dressing, as funds would have to build and unwind these cosmetic positions more often. And although this more frequent disclosure does increase administrative costs, I believe that the gains of more frequent disclosure, i.e., less window dressing and just more information to the public, to the investor, outweighs these additional costs.

The last issue I wanted to discuss with the SEC is making mutual fund information easier to understand for the average investor. Indeed, I feel that some recent developments in the mutual fund industry to sell funds via brokers have actually made it more difficult for an average investor to understand mutual funds and that actually have hurt the industry.

For example, consider the issue of multiple share classes. About 12 years ago, almost all funds in the United States, there were some exceptions but most of the vast majority of funds in the United States were either load or noload mutual funds. However around the mid-1990's, just as investors were beginning to understand the difference between a load and a no-load fund, many funds moved to multiple share classes as a result of the adoption of rule 18f–3 by the SEC in 1995. Just like other mutual funds, multiple-share-class funds represent a portfolio of underlying assets. However, unlike other funds, they have different share classes differentiated only by how investors pay fees. For example, a single-class fund only has one fee structure whereas a multiple-share-class fund can have two, three, even four different fee structures on the same underlying portfolio.

Now, I don't think the impact of these multiple-share-classes is well understood by a lot of people in the industry. To understand the impact of the multiple-share-classes consider that at the end of 1991, the Morningstar mutual funds data base indicated that there were 2,373 funds. By the end of December 2000, the same data base indicated that there were 12,029 funds; a more than fivefold increase in 9 years. However, since each share of a multiple-share-class fund is counted separately by Morningstar, these numbers are completely overstated. Indeed, when multiple share classes are adjusted for, these numbers drop to 2,322 funds, again at the end of December 1991 and only 5,349 funds. Hence, the rise of multiple-share-classes is responsible for about 69 percent of the increase in the reported number of funds over this period.

And although the stated intentions of this rule 18f–3 seem quite positive for investors, i.e., investors would now be able to choose the best fee structure that suits them without the funds having to pay the costs of creating several funds, many of the effects of this rule change have actually been quite negative for investors.

For example, one of the most obvious problems with multiple-share-class funds is that mutual fund fees have become more complicated for investors. And we have been talking about how important fees are in terms of terms. Again, indeed, just as investors were getting used to the distinction between load and no-load funds, the industry adopted an alphabet soup of fund share classes that investors now have to sift through. So after they pick a fund, they now have to pick the share class that they are actually going to undertake.

Moreover, and maybe the most negative consequence of multiple share classes, a colleague of mine, Edward O'Neal and some other people have well, have found that the introduction of multiple share classes has given rise to broker compensation arrangements that can be quite different across share classes. For example, brokers may receive more compensation for selling a deferred-load class, particularly known as a B share class, rather than a front load class share. And O'Neal documents that such incentives have lead to clear conflicts of interest as brokers try to sell a share class that is the best for them and not necessarily best for the investor.

So to conclude, I would encourage the committee to more fully support the SEC with regards to mutual fund regulation. The industry has seen its importance increase dramatically and this fact alone, just alone merits more funding for the industry's chief watchdog.

In terms of the focus of the SEC's regulation efforts, I believe that fuller disclosure with an emphasis on relatively easy-to-understand statements of fees, expenses and portfolio holdings is the way to go. At some point, mutual funds have to be self-regulating, but it is my belief that the SEC should allow investors to make more informed decisions by requiring funds to disclose much more information to the public.

Thank you.

Mr. PLATTS. Thank you, Dr. Morey. And, again, my thanks to both of you for your testimony and we will proceed into the questions.

Mr. Bogle, again, certainly your many years in the industry and your perspective of having been regulated by the SEC brings a unique perspective to our hearing today. And I wanted to say your standard that you set in that 1949 thesis statement and the high ethical standards I commend. And as I say in the political arena in my approach to politicking and person-to-person that some of my views are deemed idealistic. I say, well, idealism and realism combine; you can be an idealistic realistic or a realistic idealist. But either one I think is a worthy goal.

Mr. BOGLE. Absolutely, sir.

Mr. PLATTS. And I think that is something that is important, that your perspectives are idealistic but realistically achievable goals is important for all of us to understand.

Some of what has transpired in the mutual fund industry and with the Attorney General, and efforts on the market timing and late trading, seem to be kind of just fully known and just accepted practices, although within the ethical and legal standards that really should have been pursued. And it gets into our focus today on that strategic planning process of the SEC, its resource alloca-

tion. Given how pervasive the knowledge was of these practices, what is your view of what went wrong that the SEC was not proactive in identifying these practices that were hurting that average investor if it was so openly known?

Mr. BOGLE. I think, first of all, the Investment Company Institute, the trade association for the industry, has always had a heavy influence on the SEC staff. And the people that run this industry, the chief executives of the management companies, are persons of very high ethics but they are involved in a business that has a whole lot of things that we take for granted that we should not.

You know, Mr. Chairman, there is a wonderful quote from Upton Sinclair that says it is amazing how difficult it is for a man to understand something if he is paid a small fortune not to understand. And this is an enormously economically attractive industry. So I think they were sort of persuaded by their own rhetoric and more able to persuade to the SEC that things were not serious, they were not problems. And the ethic in our business was kind of everybody else is accepting these timers. Now our marketing department says if we do not allow market timing by a brokerage firm, they will take us off their preferred list; all that kind of thing and all the shelf space and point of sales stuff that affects this industry. And I think we did not realize how bad it was. I do not think we thought through that it was actually damaging the existing shareholders. But I have to say, and it will sound self-serving, and in a lot of ways it is self-serving, but when we started Vanguard it was to be run for the shareholders. And believe me, we have been dealing from almost the day we converted from a load system to a no-load system in 1977 with people trying to break through the doors and do market timing. And I hate to tell you, I would not dare tell you, how many of them I have almost personally thrown out. You do not like that and you know it is not good for the fund shareholders, but many felt that if it is depriving the management company of the revenues, you kind of think well it is not too bad.

Certainly some of the stuff that was criminal is an exception. But very few people thought they were behaving unethically because the system under which the industry runs and the industry ethic, if you will, we are all competing and our competitors are doing it, our peers are doing it and we do not think that there is anything too bad. I do not think the SEC really knew as much as was going on as the industry itself it did, even though that Financial Analysts Journal article was out there for anybody to read. Maybe nobody in the SEC reads the Financial Analysts Journal. I will bet they are reading them now.

Mr. PLATTS. We hope so. And, you know, as a dad I put a lot of things in perspective and I maybe better understand how my dad always commented to put things in perspective as his dad did himself when he talked about us kids. And it is almost—you know, my kids will say why can I not do that? Well, all the other kids are able to do it.

Mr. BOGLE. Yes.

Mr. PLATTS. You know, and if they can do it, why can I not? And it is just kind of unfortunate, that mentally. But certainly given the very import fiduciary duty the SEC has, just because it is accepted, certainly is it within the balance of the law. And a lot of what your

testimony brings forward is a big part of what our committee is focused on. Certainly there is certain statutory changes that are needed to account for the change in the marketplace and to keep up with those changes. But what I took from your testimony is a better enforcement in regulation of the marketplace under existing laws is really going to go a long way to protecting that investment. Your analogy to the rumble seat and under the law they should not be in the car and yet they are driving the car; that is not a change in law, it is enforcing the law. And what our hearing's focus is from the strategic allocation of resources to better enforce the law.

You certainly well highlight the challenge that the SEC had as we—you know. I was not in Congress in the 1990's, but it looked like the Federal Treasury was looking to the SEC as kind of the rainmaker for the Federal Treasury. Just generating more and more money and we are going to give you a smaller and smaller percentage of what you are generating. And instead of reinvesting that we were going the opposite direction. And manpower certainly was a prominent issue and we are seeking to address that.

Mr. BOGLE. A lot of these things did not need to have happened, sir.

Mr. PLATTS. Yes.

As we are now trying to give them manpower, give additional authority to SEC and the SEC is actively engaged thanks to the leadership of Chairman Donaldson and his staff of having a more comprehensive approach, is there one or two items that we as a subcommittee should especially be looking for in their strategic plan that they might coming forward here in the near future to us and to the general public, to investors and to the community, that we really should be especially focused on in their strategic plan?

Mr. BOGLE. Yes. I tried to list a fairly large number. I would put quite high on the list the economic study of the mutual fund industry.

Mr. PLATTS. Of those seven, that would be——

Mr. BOGLE. That would probably be my highest. And the second is one that is literally not discussed. I do not know anybody who said a word about it except you know who seems to be getting in trouble all the time with his fellows in the industry. And that is the conglomerate takeover of the industry. Is that good? What does it mean when the whole idea, their idea is to gather assets? Just the gathering the staggering amounts of assets. Now the largest mutual fund manager happens, thank God, to be an indexer. Runs $1 trillion worth of assets. Those are huge amounts of money, but when you get trying to manage them, can money be managed at that level effectively? Is there any thought about saying that a certain size of mutual fund can no longer carry out the objectives that it has in the prospectus?

Size is one. Buffet tells us that a fat wallet is the enemy of superior returns and there is not a money manager in America that does not know that, and yet we keep looking for more assets in the industry. And so that would be probably my second one.

Mr. PLATTS. Those are your top two? And those are insights. And I did appreciate, as I read the Attorney General's testimony ahead of today's hearing and as you reflected in your opening statement, how closely aligned as he talked about his three chapters, it really

is almost like you know, he had a copy of your testimony on that economic study.

Mr. BOGLE. Let me make the record clear, Mr. Chairman, that we did not share. I know you know we did not.

Mr. PLATTS. I know you did not, but certainly you dove tailed well with each other from him on the enforcement side as Attorney General and you coming from the regulated side in the industry. It really made a great joint message.

And I want to go to our ranking member and then we will come back some additional questions.

Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman.

As a former industry leader, Mr. Bogle, let me say to you, I am really impressed with your testimony (inaudible).

What must the SEC do to ensure that the financial community take these regulations seriously? They may have regulations, but they are not taken seriously.

Mr. BOGLE. Well, they are not taken seriously for a couple of reasons. First, the SEC has no criminal, as I understand it, no ability to prosecute under the law. They have to refer that over to the Justice Department. One of the great advantages Attorney General Spitzer has is he can do that. He can put people in jail. And believe me, when people start to go to jail, and we have one mutual fund executive, he happened to be named mutual fund executive the year in the year 2002, who is now in the slammer. And that is the bigger they are, the harder they fall.

So the Attorney General has something quite strong going for him. Because white collar criminals have quite a different life there when they find themselves in jail. And then we cannot expect the SEC to do that.

But I think it is strong enforcement. I think the Commission is reticent, and more reticent than they should be in making fee reductions a part of their settlements with these various mutual fund companies. There is sort of a philosophical divide between Attorney General Spitzer's approach and the Commission's approach. But I would use, you know when you get a struggle like this, a fight like this is you will, I think the SEC should use every weapon at its command. And I would say fee reduction would be an important part of that.

I would also hope that the chairman would use the bully pulpit that the chairman of the SEC has to stand up and talk much more boldly and bluntly about these abuses and about the industry in which they have occurred.

He is a terrific chairman, but I do not think he realizes the power of the bully pulpit as much as he might.

Mr. TOWNS. Right. Thank you.

Since approximately 20 percent of all pension funds are invested in mutual funds today, should that be a specific focus on how particular investments in mutual funds are regulated, that is the stake from the individual investors?

Mr. BOGLE. You raise a very, very good question, Ranking Member Towns. A really good question. Let me just give you an interesting fact.

Of the 100 largest financial institutions in America, which happen to control 56 percent of all the stock in America, the 13 are State pension funds and 87 are private firms; 78 of those 87 firms, the overwhelming majority, actually run both mutual funds and private pension accounts. The mix, in other words, it is very hard. I think we have to change our mind set and maybe even our vocabulary a little bit to talk about money managers because the issues in both classes are not very different. When you are marketing to individuals, which is the mutual fund side by and large, particularly the 401k area, you know you are marketing to a huge number of people. But you are still marketing to the institutional side and then you got salesmen out there trying to say well I am better than everybody else and all those kind of things that they do, but they are both afflicted by very much the same things.

I am not sure you need heavy regulation. The advisors of the pension plans are registered separately and are usually affiliated companies that register separately under the Investment Advisors Act. But that is, by and large, at least by my standards kind of a reporting statute. But I think there should be considerable attention given to the conflicts, I would say, in those two areas, fee setting.

Another good example is these advisors, the same advisors mind you now with different corporations in the same company, but the same organizations who will offer very low fees to State pension plans and also offer them incentive fees that say we will not take anymore fee than this unless we give you good returns. Why, one might ask, is not the same deal offered to their mutual fund clients? It seems sort of amazing, does it not? But it is not. Incentive fees in the mutual fund area are virtually nonexistent. I think 1 percent or 2 percent of all mutual funds use them, which, I think Vanguard makes up half. We like incentive fees because the adviser gets paid if he does well and pays a penalty if he does not.

So, I think you are right, that there should be some—without having a regulation that is all encompassing, certainly a parallel regulation in which there is a recognition that these two businesses are one in the same and becoming increasingly associated.

Mr. TOWNS. Let me thank you. And I thank you for all your work you are doing, and re-thank you for your testimony today. Thank you.

Mr. BOGLE. Thank you.

Mr. PLATTS. Thank you, Mr. Towns.

Dr. Morey, your study on the window dressing issue and the kind of gaming system for that investor looking at a prospective investment.

Dr. MOREY. Yes.

Mr. PLATTS. Is that something in your assessment that the SEC should have been able to identify long before your study. It seems that once you did it, and identifying the practice, it should have been something that you know was more quickly identified by those laboring in the industry. What is your assessment?

Dr. MOREY. Yes, it is something I think that they could have investigated a lot earlier. I mean, there have been evidence of window dressing in many different areas. And, you know, the economic significance of window dressing maybe is not of the level of market

timing, things of that sort. I do not know if I would put it up at that high of level. But it is something that has been an issue and anecdotally talked about, and it has been talked about in a number of research papers for many years in the recent decade.

So as I think I relayed in the paper, if you have read in the paper, so the SEC has not brought up one single investigation of window dressing. So I really think it is something that they could have looked at. And part of the reason they have not looked at it is they are just under staffed, under paid. A lot of those things that have been kind of been talked about before. So I do think it is something that they certainly looked into more. And the movement of going to more frequent disclosure, quarterly disclosure I think really does indicate that the SEC is moving in the direction of trying to, you know, be concerned about window dressing.

Mr. PLATTS. I would agree in the sense of, as we have heard from the Attorney General as well, disclosure in and of itself helps address some of these. That self regulation——

Dr. MOREY. Right.

Mr. PLATTS [continuing]. Ultimately is going to come from within the industry as we get better disclosure, whether it is on issues of window dressing or related issues; that the sunshine will help to force the industry to better regulate itself as self. But the point being made, you know, that an aggressive proactive SEC—also that I use the analogy with your student and you have a homework assignment and the teacher is actually going to call on you in class, you are more likely to pay attention to it. So if you are in industry you know that the regulators are more likely to actually look into what you are doing, you are more likely to be a little more diligent in fulfilling your duties to the investigators.

Mr. BOGLE. And if you knew your directors were going to take you to task, if you knew your fund directors were going to take you to task, which there has not been nearly of.

Mr. PLATTS. Yes, from within the industry itself, right?

Mr. BOGLE. Yes.

Dr. MOREY. I mean, the No. 1 role of the regulatory institutes is it always be bending over backward for the small investor, I really believe. And I do not think it has been doing that for the last 10 years or in many ways.

Mr. PLATTS. Well, that was actually a question I wanted for both of you, because I know Mr. Bogle you have a train to catch.

Mr. BOGLE. That is all right. I am at your service.

Mr. PLATTS. So we want to make sure—as we work with the SEC and they are coming forward with the strategic plan and where are they going to focus? And I appreciate in your talk and you are agreeing with Chairman Donaldson, the importance of the SEC being involved in the regulation of hedge funds, but how with limited resources, even though they have more, there are still ever going to be enough in any one's view, is their strategic plan. What is the right balance between large investors, a small number of them and the smaller investors but a huge number? What should we be looking for in their strategic plan? How do they truly go about their resource allocation in that regard?

Mr. BOGLE. Well, I certainly agree with Dr. Morey that the small investor needs a lot more protection than the large investor does,

and there cannot be any question about that. And sooner or later we have to try and educate the small investor about how to protect him or herself. We have gone through an era of great human greed, a great market bubble and if everything looked easy, we had for 20 years 18 percent annual returns in the stock market. Even a poor performing mutual fund probably doubled your money. And that is probably only a 5-percent return or something like that. But all those things kind of came together. You could even argue it was kind of a perfect storm.

And it is a little hard to say where the SEC should put its resources. But, you know, one thing which actually Dr. Morey inspired in my mind as I was listening to him here is that the SEC—the work that comes out of the academic community in the financial area is staggering.

You know, the personal computer has made every academic able to explore thousands of academics for every single aspect of everything that goes on in the financial fields and the work just pours out; there are three, four, five, six, seven academic journals. Some of them are written in English, some of them are written in a language with which I am not familiar. But the SEC, honestly and I am not kidding about this, should have one or two people; one who can speak the English and translate all these formulas into English and see what is worthwhile. A lot of it is not worthwhile. Some of it just priceless. But just capitalizing on the work that is done out there does not require using the research others. Using the work of others would be a very useful thing to do.

I would try and convene groups of people in the industry. I am not sure how you get them to talk. I have been lucky enough to be in a position where I can talk to Commission division, and I have talked informally actually this year to the Director of the Division of Enforcement, Steve Cutler, for whom I have the highest regard for and his whole division. And I will be talking with Paul Royee (phonetic) in Division of Investment Management.

But we ought to have people from the industry come and talk to them about, you know, about the reality as it is in the industry. Not all the double talk, not all the public relations, not all the veneer. What is really going on and are there economic issues and management issues and conflict issues that go on in this industry. And I think those things should not demand too much of SEC resources.

Once we get to the areas you could really focus on, then put the resources on them.

Dr. MOREY. Yes, I would say the same sort of thing. I mean, I really do believe that the smaller investor really most of the attention should be put in terms of regulation. Yo know, again, it comes back to the disclosure. I really do feel that, you now, individuals should be responsible to some extent about where they are investing their money, but we should be able to give them as much information in as clear a way as possible. And, you know, just multiple-share-class stuff. I can understand why the mutual fund industry wanted this, because most mutual funds are not bought, they are sold. That is literally how the industry people, they are sold to other people. But still, I mean, trying to basically protect investors by keeping it as clear, as easy to understand as possible is really

imperative. And that is what I would really stess in terms of the SEC and (inaudible) share.

Mr. PLATTS. One final question. I want to yield to Mr. Towns to wrap up this portion, but Mr Bogle, you addressed in the sense of your meeting with the Enforcement Division and sharing some of your great wealth and knowledge with them to get that kind of how things really work on the street. And I was going to ask you, I am glad to hear that type dialog is happening.

The second half of that is, Dr. Morey, based on your study and when addressing issues, has there been any effort by the SEC to reach out to you and to your fellow professors working so that you are aware of to do as Mr. Bogle has said——

Dr. MOREY. Right.

Mr. PLATTS [continuing]. Kind of just pull in your knowledge as a source of some additional information?

Dr. MOREY. Yes, there has been. We, in fact, presented this paper at the SEC not too long ago. One of my colleagues used to work at the SEC, actually, in that direction.

Mr. PLATTS. Great.

Dr. MOREY. So, yes, I do think there is some, but not enough. Not nearly enough. And I will give you one example that has worked pretty well, which is ICI, Investment Company Institute, every 2 years has put together a conference where they bring in academic, mutual fund academics and with practitioners. And although some of the practitioners are a little guarded about what the are saying, and so still there has been an incredible useful thing. Because we can ask them the questions that we are interested in, they can ask the questions.

At the last one we were really trying to talk a lot about like compensation, the stuff that Mr. Bogle was talking about. Why isn't the mutual fund manager's compensation disclosed. You could even disclose it in anonymous ways that we could do studies on it. But, you know, those kinds of issues. So that was very helpful and maybe if the SEC could do something like that in a broader way with a conference or something of that sort, it would be very helpful.

Mr. PLATTS. Thank you.

I yield to Mr. Towns.

Mr. TOWNS. Right. Thank you very much.

And let me thank you also, Dr. Morey for your testimony. And, of course, I also appreciate the fact that you have given us another invitation to the University as well. We certainly appreciate that.

Are you saying that the SEC should have a mandate for educating investors? Are you saying that should be their responsibility to spend more time in terms of making certain that investors are educated?

Dr. MOREY. I guess education——

Mr. TOWNS. Are there responsibilities in the law, I should say?

Dr. MOREY. Yes. I think they have responsibility to make sure that user funds disclose fees completely and accurately, and also clearly. Now, if that is educating, I would say yes to that. But I think it can be done very clearly and so on in the ways that you really do not have to basically, you know, put a tremendous amount of energy into educating investors. I think if you put it

down in pretty simple language and a very concise statement, I think that the education of investors really is not needed as much. It is almost really just disclosing things in a clear way.

So if that is education, yes. But I do not really see it as that. I see it as basically putting things down in a very clear easy to understand sort of method and full disclosure of those things.

Mr. TOWNS. What impact can you discern from your research in terms of the mutual funds scandals had on investors' confidence in the industry? Was that affected in any way?

Dr. MOREY. Yes, I think it initially affected it a lot. I did effect it. But, I mean, the problem is that, you know, most people when they are investing money, you know, they are doing through their pension plans and so on, they do not have that many other options and they are still investing money back into mutual funds. So, yes, I think it had a big impact initially and I think people are more weary of funds. And we have seen basically more movement toward index funds and things like that because of the fee structures and so on. But I guess just because of the very fact that this is what everybody basically invests in now or whatever does for the most part with their retirement money.

You know, there is going to be a tremendous amount of money still invested regardless of the scandal. So I mean, I think it has been sort of short term to some extent and then over the longer term, if you will, a lot of that sort of has became a—I will not say it has fallen into memory or fallen away, but it is not as prevalent as it was. OK.

Mr. TOWNS. Consistent with in terms of this morning, every witness has indicated the fact that the small investors need to be protected.

Dr. MOREY. Yes.

Mr. TOWNS. What do we do as members of the U.S. Congress to assist in that, making certain that they are protected?

Dr. MOREY. Well, I think, you know again given the resources of the SEC that, you know, they are in budget constraints and everything, I think what is most important again is disclosure. I really do think it comes down to that. And that since a certain amount of the burden has to be put on the investors, but investors have a right, the actual right to have full information about what these funds are doing. And I cannot emphasize enough that almost the academic research—I mean some research has found certain things to predict mutual fund performance better than others, but the one single thing that really comes across is expenses. Expenses clearly are the issue. If you are trying to figure out, you know, a high performing fund and once you figure out the right style that you want to be in and so on, go to a low expense fund.

And, again, when investors do not have that kind of information, when they do not really know what the actual expenses are, it makes it a very hard case to say that, you know, we are regulating industry correctly.

So I really do believe that given the resource constraints that what the SEC could be doing is really focusing on complete, easy to understand disclosure of fees and, you know, we can talk about some of these other issues. But that would be the main, main thing

I would do. But the burden, to some extent, in the investor's hands. But still with all——

Mr. TOWNS. OK.

Mr. Chairman, I am going to yield but I just am going to make this comment. I do not know whose idea it was to put them first and then allow the SEC to come last. But I tell you, that did make a lot of sense.

Mr. PLATTS. I'm not sure if Commissioner Donaldson would agree.

Mr. Bogle and Dr. Morey, we greatly appreciate your time with us today and your efforts in making sure that average investor is in the driver's seat and not in the rumble seat. And we are grateful for the knowledge you have shared with us, and look forward to perhaps having a chance to work with you again in the future.

Thank you so much.

Mr. BOGLE. Thank you very much.

Dr. MOREY. Thank you.

Mr. PLATTS. You are welcome.

We will take a minute or two break while we get to the final panel, and get started here shortly.

[Recess.]

Mr. PLATTS. OK. I think we are ready to get started with our third and final panel. Saved the best for last, right?

If I could ask our two witnesses to stand and I will administer the oath.

[Witnesses sworn.]

Mr. PLATTS. The clerk will reflect that both witnesses responded in the affirmative.

And, Mr. McConnell we will begin with you and then, Mr. Hillman your opening statement and then save questions for both of you.

If you would like to begin, Mr. McConnell.

STATEMENT OF JAMES M. MCCONNELL, EXECUTIVE DIRECTOR, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. MCCONNELL. Chairman Platts, Ranking Member Towns, thank you for the opportunity to testify on behalf of Chairman William Donaldson regarding strategic planning and the allocation of our recent funding increases.

The SEC experienced unprecedented staffing and budgetary growth over the last 3 years. And the Nation's investors and in the industry we oversee need to be assured that we have a thorough, thoughtful plan employed at this moment. Our 2005 request of $913 million is nearly twice the size of our 2002 budget and demonstrates the strong commitment by this administration to addressing the many challenges confronting the agency.

Before I begin, and perhaps a bit uncharacteristically for a Federal agency, I would like to thank the GAO staff and Rick Hillman for the work that they have done over the past 2 years in working with the SEC. Their work and recommendations have been an asset to the commission and has improved the agency's operations.

Also, I would respectfully request that in addition to my complete written statement, a copy of Chairman Donaldson's recent Congres-

sional testimony on the Commission's efforts to reform the mutual fund industry be a part of the record.

Mr. PLATTS. Without objection.

Mr. MCCONNELL. Thank you.

Since last February, the SEC has spent considerable energy examining and reforming our organizational structure, operations and our work flow processes. Our goal is to become more proactive and to better anticipate risk. We need to be able to respond quickly to our changing environment by seeing around corners and over hills. Having this ability is vital to the success of the agency and developing this capacity has been one of Chairman Donaldson's highest priorities. Right now I would like to highlight a few of our initiatives in this area.

When the Commission first received its funding increases in fiscal 2003, we began a comprehensive planning initiative to determine how best to allocate these funds. Throughout the process, the chairman's primary concern was that resources be deployed as effectively and efficiently as possible to maximize the value to taxpayers and investors alike. To achieve this objective, the chairman held a rigorous series of meetings with the heads of the divisions and major offices to review their mission, environment, goals and strategies. The chairman's office then initiated top to bottom reviews of the new organizational structure proposed by the divisions and offices to incorporate their new staff. These reviews have examined whether positions are being deployed effectively, are fully consistent with agency priories and are accompanied by the appropriate level of supervision.

Now that the initial round of reviews is complete we intend to use the process as the model for analyzing future division and office reorganizations, as staff increases.

Risk assessment. As we highlighted in the hearing last July we have initiated a new risk management program and laid the groundwork for the Office of Risk Management and Strategic Planning, the first of its kind at the Commission. Fundamentally this initiative is instilling a new spirit into our everyday activities so that we constantly are searching for new and emerging risks to investors and U.S. financial markets. We are focusing on anticipatory risk, the most difficult to assess but the most important type to try and understand.

The first stage of this new effort has been to organize internal risk teams made up of representatives from each major program area. When fully staffed, the new office will then work in coordination with the internal risk team to then apply new or resurgent forms of fraudulent, illegal or questionable activities.

In addition to fostering better communication and coordination with the Commission, the risk assessment initiative will help us proactively identify existing and emerging problem areas within our industry and adjust operations and resources accordingly.

Performance dashboards. As we discussed also during last year's hearing, the performance dashboards are management reports designed to present regular snapshots of the divisions' and offices' progress when we do budget, staffing and performance objectives. We have been generating dashboards for the last 7 months and

they continue to evolve as divisions and offices refine their performance measures.

Our dashboards are helping us identify emerging problems. They reinforce each executive's accountability for their staff, performance of this initiatives and proactively adjust operations and resources as necessary.

Strategic planning. The chairman feels strongly that completing our 5 year strategic plan is critical, not just because it is required, but also because it embodies our comprehensive strategy for the next several years. Though the plan is being completed later than we originally anticipated, we have taken the time necessary to make sure it is useful for the agency in a critical time in its history.

In particular, the strategic plan has been substantially enhanced due to the work I have just outlined in the areas of organizational review, risk assessment, and performance dashboards. The draft of the SEC's strategic plan is being reviewed by the chairman's office. It will soon be voted upon by the committee.

It was written by a team of senior managers and staff throughout the agency who actively conferred to their office or division leadership and interacted with external stakeholders.

You will receive a copy as soon as it is improved, and we look forward to your feedback.

GAO has stressed the importance of having a strategic plan upon which to base agency wide resource decisions, and we strongly concur. While we would have preferred to have a strategic plan prior to deployment of additional resources and staff, the environment in which we are operating did not permit us that luxury. As you can see from my testimony, it has been necessary for the staff to undertake multiple tasks concurrently. While our plan has been completed later than anticipated, the vision, mission and values have guided our activities for quite some time.

I now want to spend a moment to discuss the SEC's human capital. Thanks to significant budgetary help from the President and Congress, the agency received appropriations in February 2003 for resources needed to hire 842 new employees.

Our accepted service hiring authority, which would not have become law without the instrumental support of this subcommittee, was especially important because it allowed us to put critical staff in place much more quickly than would have otherwise been possible. Since 2002 we have hired about 770 new staff, 39 percent attorneys, 22 percent accountants, 22 percent examiners, and the remaining 15 percent in other positions. Approximately 107 more will begin working at the SEC by the end of June. We will then have 403 vacancies remaining, that is compared to our normal vacancy level of about 150. Of the 403 vacancies, 38 percent are attorneys, 28 percent accountants, 15 percent are examiners and 23 percent represent other positions.

We have refused to hire employees simply to fill chairs, but rather to focus on hiring the best and most appropriate people to fulfil our mission and are deployed where each staff can do the most good. By the end of the year we fully expect that our hiring efforts will achieve targeted staffing levels.

As GAO has previously identified, we would be better served by not just focusing on paying more attention to hiring but also creating a comprehensive work force planning effort to assure that we reach our human capital goals and objectives. We have begun to make progress in this area on a variety of fronts.

For example, the SEC launched the SEC University, an initiative to redesign and enhance our training and orientation programs to help staffing managers to better perform their responsibilities and to keep abreast of industry trends. We have begun to review the Commission's succession. Our preliminary findings demonstrate that we are unlikely to face in significant waves of coming retirements as is the case for much of the rest of the Federal Government.

We have implemented a new pay-for-performance system designed to reward job performance based upon employee's contributions to the Commission's overall mission.

These and other efforts have helped the SEC think and act proactively in recruiting and retaining the right staff, our most important asset.

Investments in the SEC's information technology are critical to help us delve deeper in our investigations and inspections, improve investors' access to company disclosures, and otherwise support the Commission's efforts to protect investors.

The Commission has made progress on a variety of fronts. Early this year, we hired a new Chief Information Officer to guide the agency's information technology program. In the short time since his arrival, our CIO has begun adding staff to manage a broad range of IT projects and has started to reshape our capital planning process and he will soon begin building a new IT strategic plan. This plan will guide the various IT initiatives we have or will soon have underway including a new document management system that streamlines case management, infrastructure architecture, information security enhancements, and a new design of our disclosure and review process.

For the last 2 years the subcommittee and GAO have raised important concerns regarding SEC's lack of an updated strategic plan. We agree with those concerns and that the SEC must deploy resources efficiency and effectively and respond quickly to the fast paced environment.

With the initiatives I have mentioned today we have confidence that we are proceeding down the correct path.

We once again would like to thank the subcommittee for inviting to me testimony today. These are very important issues for the Congress and for the Commission.

I look forward to addressing your questions.

[The prepared statement of Mr. McConnell follows:]

Testimony Concerning
Resource Allocations and Strategic Planning

By James M. McConnell
Executive Director, U.S. Securities and Exchange Commission

Before the House Government Reform Subcommittee on Efficiency and Financial Management, Committee on Government Reform

April 20, 2004

Chairman Platts, Ranking Member Towns, and Members of the Subcommittee:

Thank you for the opportunity to testify on behalf of the Chairman of the Securities and Exchange Commission (SEC) regarding the SEC's allocation of recently received funding increases and strategic planning. The SEC has experienced unprecedented staffing and budgetary growth over the last three years, and we appreciate fully our responsibility to utilize these resources effectively and judiciously. In fiscal 2002, our budget was $514.3 million; in 2003, it jumped to $716.3 million; and by in 2004, it was $811.5 million. The President's fiscal 2005 budget requests an additional $101.5 million, for a total program level of $913 million. This year's request is by far the largest ever proposed for the SEC and demonstrates a strong commitment to addressing the extraordinary challenges confronting the agency. The nation's investors and the industry we oversee need to be assured that we have a thorough, thoughtful plan to deploy these resources.

With this fundamental requirement in mind, I would like to update you on the strategic planning and operational initiatives that the SEC has made since Peter Derby, the SEC's Managing Executive for Operations, and I appeared before you last July. I also would respectfully request that in addition to my complete written statement, a copy

of Chairman Donaldson's recent Congressional testimony on the Commission's efforts to reform the mutual fund industry also be made part of the record.

Environment

The challenging environment in which the SEC operates has not abated since our hearing last summer. It has grown more complex. Last year, we faced accounting scandals, numerous earnings restatements, corporate and self-regulatory organization (SRO) governance issues, and analysts' conflicts of interest that severely shook investor confidence in the fairness of our markets. Prior to that, we faced the bursting of the dot-com bubble, a deluge of corporate malfeasance and fraud, and several years of constrained resource levels. More recently, the SEC has continued to uncover securities law violations in the mutual fund industry, such as those related to market timing and late trading.

The SEC's staff has been working hard to address all of these developments - from the global settlement on analysts' conflicts, to changes in SRO governance, and proposed rule changes to improve disclosures made to investors. On the enforcement side, our Division of Enforcement filed 679 enforcement actions in fiscal 2003 – more than in any previous year – and nearly 200 of these actions involved fraud or reporting violations. We have also made progress toward meeting the Sarbanes-Oxley Act requirement to review the filings of each publicly traded company once every three years.

With respect to our oversight of the mutual fund industry, we have taken a series of steps to improve our ability to identify and rectify problems early, before they can put large pools of investor savings at risk. We have increased the number of staff that inspect

investment funds and advisers by nearly 30 percent since fiscal 2002, to approximately 495 staff. With these new inspectors, the SEC has increased the frequency of examinations of funds and advisers posing the greatest compliance risks and has been able to conduct more examinations targeted to areas of emerging risk. Our inspection program also has been conducting more examination sweeps focused on issues of particular concern. Examples of some of the issues targeted include: payments by mutual funds for "shelf-space;" use of soft dollars by index funds; valuation and pricing of bond funds; fair value pricing; and practices of investment consultants. Although these areas are often highly technical, they are critical to determine whether a fund or adviser is truly operating in investors' best interests.

These programmatic changes are vital to the restoration of the public's confidence in the nation's markets and the SEC. However, they do not present a complete picture of all the SEC has undertaken since Chairman Donaldson's arrival. To fully appreciate the SEC's efforts and the changes in how we are meeting our responsibilities, one must recognize the progress that we have made in improving agency operations.

Operational Progress

Since last February, we have spent considerable energy looking at our organizational structure and our workflow processes. Our goal is to become more proactive and to better anticipate risk. We conducted a comprehensive review of our activities to determine where we can be more efficient, where additional staff and resources can best be used, and what results we are achieving for our efforts.

This multi-faceted review is fundamentally designed to help us respond quickly to our changing environment by helping us to "see around corners and over hills." Having this ability is vital to the success of the agency, and developing our capacity in this regard has been one of Chairman Donaldson's highest priorities. Toward this end, we have:

- Drafted our 2004-2009 GPRA strategic plan, which we view not as a bureaucratic exercise, but as a roadmap that will chart the course for the agency for the next several years;
- Developed and are implementing a new agency-wide risk assessment function;
- Fully implemented and expanded the scope of our "performance dashboard" initiative;
- Undertaken systematic reviews of the organizational structure of the SEC's primary operating divisions and offices;
- Hired about 770 new employees;
- Expanded our employee work-life and benefits program;
- Hired a new Chief Information Officer;
- Begun implementing our document management program; and
- Made substantial progress on the annual audit of our financial statements.

Each of these topics was raised by GAO at our last hearing as an area with room for improvement. I would now like to highlight our efforts in each of these areas for you. Admittedly, work remains to be done, but we believe we have made substantial and tangible progress.

Organizational Reviews

Soon after the Chairman joined the SEC and the agency received significant budget increases, the Commission began a comprehensive planning initiative to

determine how to best allocate these funds. Throughout the planning process, the primary concern of the Chairman and the senior leadership was that resources be deployed as effectively and efficiently as possible, maximizing the value for taxpayers and investors alike.

To achieve this objective, the Chairman held a series of meetings with the heads of the divisions and major offices to review their mission, environment, goals, and strategies. These sessions delved in detail into the offices' current operations, their requests for new staff, and their justifications for those requests. The Chairman's Office then initiated top-to-bottom reviews of the new organizational structures proposed by the divisions and offices to incorporate their new staff. These reviews have examined whether positions are being deployed effectively, are fully supported by program workload consistent with agency priorities, and whether they are accompanied by the appropriate level of supervision. This initial round of reviews is complete, and we intend to use the process as the model for analyzing future division and office reorganizations.

Risk Assessment

Just as our strategic plan, which I will discuss in a moment, should inform every aspect of our operations, so too should our risk assessment initiative. Fundamentally, this initiative is about instilling a new spirit into our everyday activities, so that we are constantly searching for new and emerging risks to investors and U.S. financial markets.

As we highlighted last July, after conducting a thorough internal review of how the agency deals with risk, we initiated a new risk management program and laid the groundwork for the Office of Risk Assessment and Strategic Planning, the first of its kind

at the Commission. The first phase of this new effort has been to organize internal risk teams made up of representatives from each major program area. The new office, working in coordination with the internal risk teams, then will push the agency to proactively identify new or resurgent forms of fraudulent, illegal, or questionable activities. In addition to fostering better communication and coordination between divisions and offices within the Commission, this initiative will help senior managers make better-informed decisions and proactively adjust operations and resources to meet new challenges. In addition, the Office of Risk Assessment and Strategic Planning will play a key role in the agency's strategic planning, ensuring that our plan remains current and directly linked to our ongoing performance dashboard initiative.

Performance Dashboards

As discussed in last year's testimony, performance dashboards are management reports designed to present regular snapshots of the divisions' and offices' progress in meeting budget, staffing, and performance objectives. We have been generating dashboards for roughly the last seven months, and they continue to evolve as divisions and offices refine their performance measures. Dashboards are becoming an increasingly important tool for the executives managing our divisions and offices, providing a more complete picture of their activities and helping to illustrate areas in need of continued improvement. Rather than motivating staff to simply "hit the numbers," our dashboards are designed to identify emerging problems, promote the discussion of solutions, and reinforce each executive's accountability for staff, performance and key initiatives. In

conjunction with our other efforts, the dashboards will help the agency proactively adjust operations and resources as environmental changes require.

Strategic Planning

The Chairman feels strongly that completing our five-year strategic plan is critical not just because it is required by law, but also because it embodies our comprehensive strategy for the next several years. Although the plan is being completed later than we originally anticipated, we have taken the time necessary to make sure it is a useful tool for the agency at a critical time in its history. In particular, the strategic plan has been substantially enhanced due to the critical work I've just outlined in the areas of organizational reviews, risk assessment, and performance dashboards. GAO has stressed the importance of having a strategic plan upon which to base agency-wide resource decisions, and we strongly concur with this view. While we would have preferred to have a mature strategic plan prior to deploying our additional resources and staff, the environment in which we were operating did not permit us that luxury. As you can see from my testimony, we have had to undertake multiple efforts concurrently. However, its vision, mission, and values have guided our activities for quite some time.

We started developing the agency's 2004-2009 strategic plan by convening a team of senior managers and staff upon Chairman Donaldson's arrival at the Commission last spring. The team, comprised of representatives from sixteen of the SEC's divisions and offices, possesses extensive knowledge of the SEC's programs and major initiatives. In developing the strategic plan, the team considered and discussed the condition of domestic and international securities markets, recent changes in the marketplace,

legislative developments, and issues affecting investors and the general public. Organizational considerations such as human capital, diversity, financial resources, and technology also were evaluated.

The team crafted a new strategic vision, mission, core values, and goals that better reflect the challenges and opportunities the Commission now faces, and identified the initiatives we would undertake to achieve these goals. Throughout development of the plan, the team actively conferred with their office or division leadership and interacted with external stakeholders. Simultaneously, senior agency leadership held a continuing dialogue, including an offsite retreat, to discuss and evaluate the Commission's new strategic priorities.

A draft of the SEC's strategic plan is currently being reviewed by the Chairman's Office and will soon be voted upon by the Commission. I will provide you a copy of our strategic plan as soon as it is approved and look forward to your feedback.

New Hires, Training, and Workforce Planning

Thanks to significant budgetary help from the President and Congress, the agency received appropriations in February 2003 for resources needed to hire 842 new employees. Also, in July 2003, President Bush signed the "Accountant, Compliance, and Enforcement Staffing Act of 2003," that provided the SEC with the same expedited hiring authority for accountants, economists and securities compliance examiners as it has for lawyers. This authority, which would not have become law without the instrumental support of this Subcommittee, was especially important because it allowed

us to use our additional resources to put critical staff in place much more quickly than would otherwise have been possible.

Since December 2002, we have hired about 770 new staff – 39 percent as attorneys, 23 percent as accountants, 23 percent as examiners, and the remaining 15 percent to fill other positions. Approximately 107 new staff members will begin working at the SEC by the end of June – roughly 38 percent of them as accountants and another 36 percent as attorneys.

Hiring must be viewed in connection with the agency's ability to retain staff. The SEC traditionally has operated with a vacancy rate of approximately 5 percent or higher. The Commission's turnover rate in fiscal year 2001 was approximately 8 percent, but had previously risen as high as 13.8 percent. Pay parity has proved to be an important tool for reducing staff turnover, as GAO has acknowledged. Since it was approved, the turnover rates dropped to 1.2 percent in fiscal year 2002 and 1.5 percent in fiscal year 2003.

Our ability to hire staff more expeditiously and to pay them at more competitive levels have been very beneficial to the agency. However, as GAO has previously pointed out, we would be better served by not just focusing on pay and hiring, but by also creating a comprehensive workforce planning effort to ensure that we reach our human capital goals and objectives. We have begun to make progress in this area. On top of our comprehensive plan to deploy and reorganize staff, we have also focused our energies on enhanced training and benefits. For example, the SEC has launched SEC University – an initiative that offers online and in person courses for managers and line staff to help them perform their responsibilities better and keep abreast of industry changes and trends. We

also have significantly enhanced our recruitment and orientation programs, to continue to attract high-quality applicants and to ensure that they start their jobs at the SEC firmly grounded in the agency's culture, mission, and values.

As part of the continuing development of our pay parity program, we have signed a contract to provide all employees, their spouses and dependents with enhanced vision and dental services. This benefit, which we negotiated with our employee union, is in addition to the increased percentage of healthcare premiums that the SEC now covers, our tuition repayment program, and emergency childcare benefits. We have also begun to review the Commission's succession planning needs, which have preliminarily shown that we are unlikely to face a significant wave of upcoming retirements, as is projected to occur throughout the rest of the federal government.

We have likewise fully implemented the Commission's new pay-for-performance system, which is designed to reward job performance based on employee contribution to the Commission's overall mission. This program is helping to ensure that the SEC's talented pool of experienced, dedicated, high-quality staff remains strong. These changes help to ensure an exciting and dynamic workplace that rewards leadership, commitment, dedication, and contributions.

Notwithstanding improvements in retention, we continue to have vacancies. After the 107 new staff members join us through June, we will have 403 (or 11 percent) vacancies remaining, of which about 150 may be considered due to normal attrition levels. Of the 403 vacancies, approximately 150 (or 38 percent) are attorney positions; approximately 110 (or 28 percent) are accountant positions; approximately 50 (or 13 percent) are examiner positions, and about 90 (or 23 percent) represent other positions.

Recruiting and hiring the most qualified individuals takes time but is critical to the Commission's success. We have refused to hire employees simply to fill chairs, but rather are focused on hiring the best and most appropriate people to fill these important positions, and are keenly focused on where each staff person can do the most good. By the end of the year, we fully expect that our hiring efforts will achieve targeted staffing levels.

Information Technology

Investments in the SEC's information technology are critical to help us delve deeper in our investigations and inspections, improve investors' access to company disclosures, and otherwise support the Commission's efforts to protect investors. The Commission has made progress on a variety of fronts, including on many issues that GAO has raised previously. Early this year, we hired a new Chief Information Officer (CIO) to guide the agency's information technology program. In the short time since his arrival, our CIO has begun adding staff with the skills necessary to manage a broad range of IT projects and has started to reshape the activities of our Information Officers' Council and our IT Capital Planning Committee. Through these initiatives, the SEC will be better positioned to develop and maintain a state-of-the-art information technology program, based on a solid IT strategic plan that everyone understands, embraces, and supports. This comprehensive, multi-year strategic program, when completed, will help the Commission to more effectively support the enforcement, inspection, and other programmatic and regulatory functions.

We are moving forward on several critical technology projects that are fundamental to the agency's IT programs. **Electronic document management** will provide agency-wide systems and processes for electronically capturing, searching, and retrieving investigative and examination materials and integrating them into the workflow of our staff. As a result, enforcement and examination staff will no longer need to spend countless hours poring through millions of pages of documents, as is often the case now. The system also will be critical to maintain these files in case of a major disaster. The initial phase of the system should be fully operational in fiscal year 2005, and will continue to be integrated with data-mining, case tracking and correspondence systems.

We also have continued to focus on streamlining our **enterprise architecture** and our business processes. Our IT and program staff are working to restructure Commission filings and forms to eliminate redundant data, particularly within the EDGAR filing system. We are actively pursuing a strategy for improving the filing and disclosure process, making it possible for investors and SEC staff to more easily analyze company data by using structured filings and "tagged data" through tools such as XBRL.

Finally, we are making substantial investments in state-of-the-art **information security.** Our upgraded "point-to-point" network will be operational later this year, allowing continued communications between remaining SEC sites in the event that a disaster forces headquarters or the off-site operations center to close. At the end of this calendar year, we also should complete the construction of the Commission's alternate data center, which will help prevent any future disruption. In addition, the Commission is currently undergoing a complete security certification and accreditation for current and future information and financial systems.

Audited Financial Statements

The recently enacted "Accountability of Taxpayer Dollars Act" requires the SEC to meet all Federal accounting guidelines and to be audited annually. The SEC recognizes the importance of leading by example. With a vision of being the standard against which Federal agencies are measured, we have developed an aggressive plan to allow for an audit of our financial statements this year, far earlier than the five years large federal agencies were given to produce their first audited financial statements.

One aspect of this plan includes the resolution of several complicated accounting issues. For example, one challenge is how best to classify certain fines and penalties that are levied by the Commission but collected and disbursed by non-SEC receivers and trustees, while another priority is the improvement of our financial management systems and internal controls.

An external assessment of the Commission's financial management systems in 2002 did not find any systematic problems, but did identify areas with room for improvement. To address these areas, we formed internal task forces, hired additional staff, and enlisted contractor support. With much work already concluded, we are confident we have taken the necessary steps to resolve any issues of internal control that may have been revealed by the audit.

Conclusion

Over the last two years, this subcommittee and GAO have raised valid concerns regarding the SEC's lack of an updated strategic plan and need to develop a

comprehensive workforce planning effort. We agree that it is imperative that the SEC position itself appropriately so that we can respond quickly to changes in our environment and deploy resources efficiently and effectively. By closing in on the ability to "see around corners and look over hills" we have been addressing GAO's concerns. We have a strategic plan, soon to be approved, that will guide our activities for the next several years; a workforce plan for filling the remaining vacancies and training staff; and performance measurement and risk assessment functions that will help ensure that we remain on track and are better able to foresee developing trends. These efforts give us confidence that we are proceeding down the correct path.

I would once again like to thank the Subcommittee for inviting me to testify before you today. I look forward to addressing any questions that you may have.

Mr. PLATTS. Thank you, Mr. McConnell.
Mr. Hillman?.

STATEMENT OF RICHARD HILLMAN, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GENERAL ACCOUNTING OFFICE

Mr. HILLMAN. Thank you very much. I am pleased to be here today to discuss the Securities and Exchange Commission's ongoing strategic planning effort and the challenges that it faces in proactively overseeing the Nation's mutual fund industry.

As has been discussed in the last 20 years, mutual funds have grown from under $400 billion to over $7.5 trillion in assets, and that becomes vital components of a financial security of more than 95 million American investors estimated to own them. However, as you know, various allegation of misconduct and abusive practices involving mutual funds have recently come to light. As a result insuring that SEC has the necessary resources and strategic focus to adequately oversee our nation's mutual fund industry has never been more important.

My testimony today discusses how the abusive practices involving mutual funds came to light and SEC's subsequent responses, SEC's plans for increasing its staffing in the divisions and offices responsible for overseeing mutual funds and the progress it has made in developing a strategic plan. And also challenges that may be affecting SEC's ability to effectively oversee the industry.

Regarding our first objective and abusive practices in the mutual fund industry came to light, we found that in late 2003 state authorities were the first to act against various abusive practices in the mutual fund industry, but since then SEC has taken swift and vigorous action designed to punish wrongdoers and better prevent a detected use of practices in the future. SEC did not identify these abusive practices involving mutual funds for various reasons.

According to SEC staff many of the cases involving fraud and collusion among personnel in such activities is very hard to detect in routine examinations. Also, according to testimony by the head of SEC office that conducts mutual fund examinations, SEC examiners did not reveal these practices because their examinations focused primarily on the operations of the mutual fund and trading of the funds portfolio security practices, which are areas we have acknowledged potential for abuse. As a result, their examinations did not generally address the trading in the funds own shares.

SEC also faced resource challenges for years that have affected its ability to conduct oversight in the mutual fund industry and in other areas. For example, we reported on SEC's difficulties during the 1990's to keep pace with the growth in the industry and its inability to examine funds and investment advisers frequently. In prior testimony the Director of the SEC's office that conducts examinations noted that prior to 1998 SEC's examinations of mutual fund firms have been as infrequent as once every 12 to 24 years. However, since these abuses have come to light, SEC and the National Association of Security Dealers which oversees the broker dealers that sell fund shares have acted vigorously to address inappropriate practices in the mutual fund industry.

For example, SEC has already taken 15 enforcement actions that involve late trading and inappropriate market timing. SEC and the National Association of Security Dealers also have issued at least 9 proposed rules to address abusive practices in the mutual fund industry. SEC has also taken some actions that address longstanding concerns over mutual fund practices, including the lack of transparency of some fund fees and costs and the potential for conflict of interest in fund distribution and sales practices.

Regarding our second objective on SEC's staffing decisions and progress on developing a strategic plan we report that after experiencing an extended period in which increases in SEC's workload grew faster than its staffing and other resources, SEC has received recent budget increases that have begun to allow it to increase its staffing, including positions in the divisions and offices with responsibility for mutual fund regulation oversight and enforcement. However, SEC has taken these actions without the benefit of an updated strategic plan to guide their staff deployment and the divisions and offices with responsibility for mutual funds followed various steps for determining their staffing needs. In the absence of a complete and updated strategic plan that identifies its key mission related goals, we were unable to determine whether SEC's recent allocation decisions made the best possible use of its resources. In making these decisions, SEC has obviously increased staffing in key areas, including providing additional resources to develop rules, examine participants and pursue enforcement actions against abusive practices in the mutual fund industry. However, without a complete and current strategic plan that outlines the agency's priorities, the agency lacks a key guide for ensuring that it is deploying its resources across these areas in the most efficient way to achieve the most effective outcomes.

Regarding our final objective, we outlined four agency wide challenges that may be affecting SEC's ability to oversee the mutual fund industry. These challenges include improving its ability to head off major problems before they occur by better anticipating and detecting abuses in the securities industry. SEC also faces challenges in hiring and retaining all the staff that it needs to achieve its mission as demands on staff continue to grow. Moreover, SEC has experienced difficulties in obtaining the information technology it needs to effectively oversee the mutual fund industry.

Finally, SEC faces challenges in overcoming impediments and ability to gather information, cooperate with other law enforcement authorities and collect moneys owed. Overall, SEC must effectively address these challenges and each of these are on their plate to address if they are to successfully restore and in the long run maintain investor confidence in our securities markets.

This concludes my prepared statement. I would be pleased to address any questions.

[The prepared statement of Mr. Hillman follows:]

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform, House of Representatives

For Release on Delivery
Expected at 10:30 a.m. EST
Tuesday, April 20, 2004

SEC OPERATIONS

Oversight of Mutual Fund Industry Presents Management Challenges

Statement of Richard J. Hillman, Director,
Financial Markets and Community Investment

GAO
Accountability * Integrity * Reliability

GAO-04-584T

April 20, 2004

GAO
Accountability • Integrity • Reliability

Highlights

Highlights of GAO-04-584T, a testimony to the Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform, House of Representatives

SEC OPERATIONS

Oversight of Mutual Fund Industry Presents Management Challenges

Why GAO Did This Study

Having grown to over $7.5 trillion in assets, mutual funds have become vital components of the financial security of more than 95 million American investors. However, in 2003, various allegations of misconduct and abusive practices involving mutual funds came to light. Therefore, ensuring that the Securities and Exchange Commission (SEC), which has primary oversight of the mutual fund industry, has the necessary resources and strategic focus to adequately oversee fund practices has never been more important. To assess how SEC is positioned to oversee mutual funds, GAO reviewed (1) how the abusive mutual fund practices were identified and SEC's subsequent responses, (2) SEC's plans for increasing its staffing in the divisions and offices responsible for overseeing mutual funds and its progress in developing a new strategic plan to guide staff deployment, and (3) the challenges SEC faces in overseeing the mutual fund industry.

What GAO Recommends

Although this testimony statement makes no recommendations, GAO discusses challenges that SEC will have to successfully overcome to improve its effectiveness and restore investor confidence in the securities markets.

www.gao.gov/cgi-bin/getrpt?GAO-04-584T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard Hillman at (202) 512-8678 or hillmanr@gao.gov.

What GAO Found

In late 2003, state law enforcement authorities were the first to bring to light various abusive practices in the mutual fund industry. SEC did not identify these practices because detecting fraud in routine examinations is difficult and it has been challenged to keep pace with the rapid growth of the mutual fund industry using its existing resources. However, since the abuses were identified SEC has acted vigorously to address these inappropriate practices, including taking various enforcement actions to punish wrongdoers and issuing numerous rule proposals designed to better prevent or detect abusive practices in the future.

After years during which its workload grew faster than its resources, SEC recently received budget increases that have allowed it to significantly increase its staffing. As shown in the table below, SEC also plans to significantly increase the numbers of staff that oversee mutual funds. However, SEC made these allocation decisions without the benefit of an updated and complete strategic plan, which it is preparing but has yet to finalize. As a result, GAO was unable to determine whether SEC has optimally allocated its limited resources to achieve the greatest benefits.

Although it has received additional resources in recent years, SEC faces a number of agencywide challenges impacting its mission and ability to oversee the mutual fund industry. These include improving its ability to better anticipate and detect problems in the industry and identifying and obtaining all the staff it needs to achieve its mission. SEC has experienced difficulty in effectively implementing various agencywide information technology initiatives, such as an electronic document imaging system and projects needed by units responsible for mutual funds. SEC also has various gaps in its authority that impede its ability to gather information, cooperate with other law enforcement authorities, and collect monies owed by violators.

Staff Positions for SEC Divisions and Offices with Responsibilities for Mutual Fund Regulation, Oversight, and Enforcement, at Fiscal Year End

SEC Unit	Actual 2002	Actual 2003	Estimated 2004	Requested 2005	Percent change, 2002-2005
Investment Management Division	173	167	190	200	16%
Office of Compliance Inspections and Examinations[a]	397	439	545	579	46
Enforcement Division[b]	980	1,016	1,248	1,278	30

Source: GAO analysis of SEC data.

Notes:

[a] These include only staff conducting or supporting mutual fund and investment adviser examinations.

[b] These include staff that conduct enforcement of all securities activities.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the Securities and Exchange Commission's (SEC) ongoing strategic planning efforts and the challenges that it is facing to proactively oversee our nation's mutual fund industry. In the last 20 years, mutual funds have grown from under $400 billion to over $7.5 trillion in assets and have become vital components of the financial security of the more than 95 million American investors estimated to own them. These funds have also grown to represent a significant portion of the nation's retirement wealth with 21 percent of the more than $10 trillion in pension plan assets now invested in mutual funds. However, various allegations of misconduct and abusive practices involving mutual funds have recently come to light. As a result, ensuring that SEC has the necessary resources and strategic focus to adequately oversee our nation's mutual fund industry has never been more important.

Today, I will discuss our work examining how well SEC is positioned to effectively oversee the mutual fund industry. Specifically, I will discuss (1) how the abusive practices involving mutual funds came to light and SEC's subsequent responses, (2) SEC's plans for increasing its staffing in the divisions and offices responsible for overseeing mutual funds and its progress in developing a new strategic plan to guide staff deployment, and (3) challenges that may be affecting SEC's ability to effectively oversee the mutual fund industry. In preparing this testimony, we summarized perspectives gained from our recent series of reports and testimonies on practices in the mutual fund industry.[1] In addition, we also relied on information gathered from our previous and ongoing work involving SEC's resources and strategic planning efforts.[2] We also met with SEC officials to

---

[1]See U.S. General Accounting Office, *Mutual Funds: Information on Trends in Fees and Their Related Disclosure*, GAO-03-551T (Washington, D.C.: Mar. 12, 2003); *Mutual Funds: Greater Transparency Needed in Disclosures to Investors*, GAO-03-763 (Washington, D.C.: June 9, 2003); *Mutual Funds: Additional Disclosures Could Increase Transparency of Fees and Other Practices*, GAO-03-909T (Washington, D.C.: June 18, 2003); *Mutual Funds: Additional Disclosures Could Increase Transparency of Fees and Other Practices*, GAO-04-317T (Washington, D.C.: Jan. 27, 2004); and *Mutual Funds: Assessment of Regulatory Reforms to Improve the Management and Sale of Mutual Funds*, GAO-04-533T (Washington, D.C.: Mar. 10, 2004).

[2]See U.S. General Accounting Office, *Securities and Exchange Commission: Human Capital Challenges Require Management Attention*, GAO-01-947 (Washington, D.C.,: Sept. 17, 2001); *SEC Operations: Increased Workload Creates Challenges*, GAO-02-302 (Washington, D.C.: Mar. 5, 2002); and *Securities and Exchange Commission: Preliminary Observations on SEC's Spending and Strategic Planning*, GAO-03-969T (Washington, D.C.: July 23, 2003).

discuss the status of their strategic planning efforts, including their plans to oversee the mutual fund industry. Finally, we reviewed SEC budget-related documents for fiscal years 2003 and 2004, and its 2005 budget request. We conducted our work from March to April 2004 in accordance with generally accepted government auditing standards.

In summary, in late 2003 state authorities were the first to bring a case after being alerted to various abusive practices in the mutual fund industry. Although SEC is the organization primarily responsible for oversight of the mutual fund industry, it did not identify these abusive practices because of the difficulty of detecting fraud, the lack of focus on the trading of fund shares in its examinations, and the challenges it faces in overseeing a growing industry using its existing resources. However, since the abuses came to light, SEC has taken various enforcement actions and issued numerous rule proposals designed to punish wrongdoers and better prevent or detect abusive practices in the future.

After years in which its workload grew faster than its resources, SEC recently received budget increases that have allowed it to significantly increase its staffing, including expanding the staff in the divisions and offices with mutual fund oversight responsibilities. However, SEC made these allocation decisions without the benefit of an updated and complete strategic plan. As a result, we are unable to determine whether SEC has optimally allocated its limited resources to achieve the greatest benefits.

In addition, SEC continues to face a number of challenges in improving and maintaining an effective mutual fund oversight structure, including improving its ability to better anticipate and detect problems in the industry and hiring all the staff it intends to bring on board in the coming years. In trying to improve its oversight effectiveness, SEC is also challenged to obtain and make effective use of information technology and faces various gaps in its authority that impede its ability to gather information, cooperate with other law enforcement authorities, and collect the monies owed by violators.

State Authorities Were First to Uncover Mutual Fund Trading Abuses but SEC Has Since Acted Swiftly to Address Problems

State authorities uncovered various abusive practices in the mutual fund industry in 2003, but since then SEC has taken swift action designed to punish wrongdoers and better prevent or detect abusive practices in the future. In September 2003, the Attorney General of the State of New York filed a case alleging abusive practices involving mutual funds. After receiving a tip, the Attorney General's staff investigated and filed fraud charges against a hedge fund manager for arranging with several mutual fund companies to improperly trade in fund shares and profit at the expense of other fund shareholders.[3] The abuses in this case, and in others subsequently filed, included allegations of late trading and market timing. Late trading occurs when investors are able to illegally purchase or sell mutual fund shares after the 4:00 p.m. Eastern Time close of U.S. securities markets, when funds typically price their shares.[4] Market timing occurs when certain fund investors place orders to take advantage of temporary disparities between the share value of a fund and the values of the underlying assets in the fund's portfolio. Although not illegal, most mutual funds discourage such trading because it increases their costs and lowers returns for their long-term investors.[5] These inappropriate market timing cases generally involved either fund companies with stated policies against such trading that were facilitating market timing for selected

[3]A hedge fund is generally an entity that holds a pool of securities and perhaps other assets whose securities are sold to a limited number of high income or high net worth individuals or institutional investors through private placements. As a result, hedge fund offerings are not required to be registered under the Securities Act of 1933 and hedge funds are not registered as investment companies under the Investment Company Act of 1940.

[4]Under current rules, mutual funds accept orders to sell and redeem fund shares at a price based on the current net asset value, which most funds calculate once a day at 4:00 p.m. Eastern Time. Orders received after this time are required to be executed at the next day's asset value. Many investors, however, purchase mutual fund shares through other intermediaries such as broker-dealers, banks, and pension plan administrators. Because of the time required to combine and process these orders, SEC rules currently permit such intermediaries to forward the order information to funds after 4:00 p.m. An investor engaging in late trading is allowed to buy or sell shares at the current day's price after 4:00 p.m. With knowledge of developments in the financial markets that occurred after 4:00 p.m., such investors have an unfair opportunity for profits that is not provided to other fund shareholders.

[5]Reduction of the returns of a fund's long-term investors can occur, for example, when a U.S. mutual fund uses the last traded price for foreign securities (whose markets close hours before the U.S. markets) to value their portfolio. Opportunities for market timing can happen when events occur between the close of foreign securities markets and the close of U.S. securities markets that are likely to cause significant movements in the prices of those foreign securities when their home markets reopen. Investors with knowledge of such market-moving events and knowledge of a mutual fund's portfolio holdings can make swift profits, or limit losses, at the expense of long-term fund investors.

investors or broker-dealers or others that took deceptive actions to assist their customers to conduct market timing transactions.

Since this case was filed, the New York State Attorney General's Office has filed at least 10 additional cases involving mutual funds, broker-dealers, and other entities that were involved in late trading or market timing abuses. As of March 2004, state legal or regulatory authorities in at least three other states, including Massachusetts (3 cases), New Jersey (1 case), and Colorado (1 case) have taken actions against participants in the mutual fund industry for their involvement in late trading, market timing, or other abuses. Some of these cases also allegedly involved mutual fund executives or employees who were conducting market-timing activities in their own firms' funds.

SEC did not identify these abusive practices involving mutual funds for various reasons. According to SEC staff, many of the cases involved fraud and collusion among personnel and such activity is very hard to detect in a routine examination. Also, according to testimony by the head of the SEC office that conducts mutual fund examinations, SEC examiners did not reveal these practices because their examinations focused primarily on the operations of the mutual fund and trading of the fund's portfolio securities practices with an acknowledged potential for abuse. As a result, their examinations did not generally address the trading in the fund's own shares. SEC has also faced resource challenges for years that have affected its ability to conduct oversight in the mutual fund industry and other areas. For example, we reported on SEC's difficulties during the 1990s to keep pace with the growth in the industry and its inability to examine funds and investment advisers frequently.[6] In recent testimony, the director of the SEC office that conducts examinations noted that, prior to 1998, SEC examinations of mutual fund firms had been as infrequent as once every 12-24 years.[7] Scarce resources may have also affected SEC's

[6]See U.S. General Accounting Office *Investment Advisers: Current Level of Oversight Puts Investors at Risk*, GGD-90-83 (Washington, D.C.: June 26, 1990); *Bank Mutual Funds: Sales Practices and Regulatory Issues*, GGD-95-210 (Washington, D.C.: Sep. 27, 1995); and *Mutual Funds: SEC Adjusted Its Oversight in Response to Rapid Industry Growth*, GGD-97-67 (Washington, D.C.: May 28, 1997).

[7]See U.S. Securities and Exchange Commission, Lori A. Richards, Director, Office of Compliance Inspections and Examinations, *Testimony Before the U.S. Senate Committee on Banking, Housing and Urban Affairs Concerning Investor Protection Issues Regarding the Securities and Exchange Commission's Examinations of Mutual Funds* (Mar. 10, 2004).

decision to, unfortunately, not follow up on information it obtained regarding the recent wrongdoing in the mutual fund industry. In the summer of 2003, SEC staff had received a tip from a former fund employee who was aware of how his former employer was accommodating market timing by some investors, but SEC staff ultimately chose not to use further resources to pursue this case. The former fund employee then reported the matter to the Massachusetts Securities Division, which subsequently took action against the firm's executives. As a result of another tip, however, the SEC staff promptly recommended and brought an enforcement action against the fund complex and two portfolio managers based on market timing and excessive short-term trading by investment professionals employed by the fund complex.

However since these abuses have come to light, SEC and NASD, which oversees the broker-dealers that sell fund shares, have acted vigorously to address inappropriate practices in the mutual fund industry. For example, SEC has sent numerous requests for information to funds and broker-dealers about their trading practices. SEC's preliminary analysis of these data show that 25 percent of responding broker-dealers had accepted orders after the 4:00 p.m. close and 30 percent allowed market timing. Since September 2003, SEC also has taken 15 enforcement actions that involved late trading and inappropriate market timing, in many cases against some of the same participants also pursued by state authorities. As of March 2004, NASD has also brought multiple enforcement cases against broker-dealers, including a February 2004 case against one of its broker-dealer members that failed to prevent market timing occurring in one of its affiliated firm's mutual funds.

SEC and NASD also have issued at least 11 rule proposals to address abusive and other practices in the mutual fund industry. For example, to address late trading and market timing, SEC issued proposed rule changes that would require orders for mutual fund shares to be processed by intermediaries and received by funds or their agents by 4:00 p.m.[8] SEC is also proposing a rule that would require that funds charge investors

[8]See Securities and Exchange Commission, Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares, Release No. IC-26288 (Dec. 11, 2003). Because many of the cases of late trading involved orders submitted through intermediaries, including banks and pension plans not regulated by SEC, this proposal requires that to obtain the current day's price, orders to purchase or redeem mutual fund shares be received by a fund, its transfer agent, or a registered clearing agency before the time the fund calculates the net asset value price of its shares, which for most funds occurs at 4:00 p.m. Eastern Time.

holding fund shares less than 5 days a 2-percent redemption fee, which would reduce the likely profitability of short-term trading strategies involving late trading or market timing.[9] SEC also proposed that funds disclose information about their policies regarding market timing and their use of a pricing technique called fair-value pricing, which is designed to better ensure that fund shares are priced accurately and thus are less susceptible to market timing.[10] SEC's Commissioners approved these rules on April 13, 2004.

In addition to issuing proposals to address late trading and market timing, SEC has also taken some actions that address longstanding concerns over other mutual fund practices, including the lack of transparency of some fees and costs and the potential for conflicts of interest in fund distribution and sales practices. Some of the actions SEC and NASD are proposing would require greater disclosure of fees that funds charge or the payments that broker-dealers receive from fund firms for marketing certain funds. We discussed these and the late trading and market timing proposals and our views on them in testimony for the Senate Committee on Banking, Housing and Urban Affairs on March 10, 2004.[11]

Although SEC and the other regulators have acted swiftly to respond to the revelations of abusive mutual fund trading practices, other issues warrant SEC's continued attention. For example, SEC is seeking information on how fund advisers use investors' dollars to obtain research. This practice, called soft dollars, involves fund advisers receiving research or other services from broker-dealers in exchange for the commissions the advisers pay on trades conducted in fund portfolio securities. Although this practice can benefit the fund's investors, whose assets are used to pay

[9]See Securities and Exchange Commission, Proposed Rule: Mandatory Redemption Fees for Redeemable Fund Securities, Release No. IC-26375A (Mar. 5, 2004).

[10]See Securities and Exchange Commission, Proposed Rules: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Release No. IC-26287 (Dec. 11, 2003). Specifically, this proposal would require mutual funds to disclose in their prospectuses the risks to shareholders of the frequent purchase and redemption of investment company shares, and fund policies and procedures pertaining to frequent purchases and redemptions. The proposal also would require funds to explain both the circumstances under which they would use fair-value pricing and the effects of using fair-value pricing. Fair-value pricing involves the use of models or other analytical techniques funds use to adjust the prices of a fund's portfolio securities in cases in which the last traded price for a security does not reflect its current market value.

[11]See GAO-04-533T.

these commissions, it can also create conflicts of interest or potential for abuse. Given the increased spotlight Congress and regulators are placing on the mutual fund industry, in our view, the time is right to address the conflicts created by soft-dollar arrangements. In addition, we have identified other actions that SEC should take that would improve disclosure of mutual fund fees, thus improving investor awareness of the fees they pay on their mutual fund investments. These actions would increase the transparency of fund fees and likely enhance competition among funds on the basis of the fees charged investors.

SEC Has Increased Resource Allocations Without the Benefit of An Updated Strategic Plan

After experiencing an extended period in which increases in SEC's workload grew faster than its staffing and other resources, SEC has received recent budget increases that have begun to allow it to increase its staffing, including positions in the divisions and offices with responsibilities for mutual fund regulation, oversight, and enforcement. However, SEC has taken these actions without the benefit of an updated strategic plan to guide staff deployment and the divisions and offices with responsibilities for mutual funds followed varying processes to determine their staffing needs. As a result, it is difficult to determine whether SEC has optimally allocated its limited resources to achieve the greatest benefits.

Additional Resources SEC Receives to Address Workload Imbalances Will Also Benefit Mutual Fund Oversight

After years of facing imbalances in its workload, SEC recently received additional resources that can help it more effectively oversee the securities markets, including the mutual fund industry. In March 2002, we reported that the growth rate of demands on SEC's staff, including the number of corporate and regulatory filings they must review, the complaints and allegations of wrongdoing they must investigate, and the numbers of mutual funds, investment advisers and other entities they must examine, had increased by about 60 percent from 1996 to 2000.[12] The rapid growth of the mutual fund industry during this time also posed challenges to SEC's staff. For example, the number of mutual funds in existence grew from about 4,500 at the end of 1993 to over 8,100 by the end of 2000. In addition, the issues that SEC staff had to address had also become more complex. However, SEC's staff resources during this period remained relatively flat. As a result, SEC's ability to fulfill its mission had become

[12]GAO-02-302.

increasingly strained because of the imbalance between its workload and staffing resources.

Following the issuance of our March 2002 report, several high-profile corporate failures and accounting scandals came to light in 2002. In response to the resulting demands that public companies be held more accountable for information they report to investors, Congress passed the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley).[13] The act, which addressed a number of concerns involving corporate governance, auditor independence, and regulation and oversight of the accounting profession, also provided additional resources to SEC. Subsequently, Congress appropriated $716 million for SEC in 2003, an increase of 45 percent over its fiscal year 2002 budget. SEC was directed to use this increase both to add personnel and acquire new information technology to increase its effectiveness. The new personnel were expected to assist SEC in addressing its workload imbalance and to help it conduct the additional reviews of corporate filings mandated by the act. In recognition of the important role SEC plays in ensuring the integrity of U.S. securities markets, it has continued to receive additional budgetary resources since then with an appropriation for 2004 of $811.5 million and a requested budget of $913 million for 2005.

In addition to addressing other needs with these additional resources, SEC has also been able to respond to the mutual fund scandals by increasing the staff allocated to the three primary divisions and offices within the agency responsible for mutual fund regulation, oversight, and enforcement. Within SEC, the Division of Investment Management is responsible for creating rules and reviewing filings for mutual funds and investment advisers.[14] Staff in SEC's Office of Compliance Inspections and Examinations (OCIE) conducts examinations and inspections of mutual funds companies and investment advisers.[15] Finally, staff in SEC's Division of Enforcement investigate possible violations of securities laws, including

[13]Pub. L. No. 107-204.

[14]In addition to overseeing mutual funds and investment advisers, the Division of Investment Management also oversees entities required to register with SEC under the Public Utility Holding Company Act of 1935.

[15]In addition to investment management-related examinations, OCIE also oversees the activities of self-regulatory organizations and conducts their own reviews of broker-dealers, exchanges, and other entities active in the securities industry.

the Investment Company Act of 1940 and the Investment Advisers Act of 1940, and pursue legal actions against violators.[16]

To address the mutual fund scandals, SEC has plans to substantially increase the staffing in the units responsible for mutual fund oversight. As shown in table 1, between 2002 and 2005, SEC plans to increase the staffing for OCIE and the Division of Enforcement by 46 and 30 percent, respectively. SEC also plans to increase the staffing within the Division of Investment Management by 16 percent. SEC staff told us that many of the new personnel will be working on mutual fund issues.

Table 1: Staff Positions for SEC Divisions and Offices with Responsibilities for Mutual Fund Regulation, Oversight, and Enforcement, at Fiscal Year End

SEC Unit	Actual 2002	Actual 2003	Estimated 2004	Requested 2005	Percent change 2002-2005
Investment Management Division[a]	173	167	190	200	16%
OCIE[b]	397	439	545	579	46
Enforcement Division[c]	980	1,016	1,248	1,278	30

Source: GAO analysis of SEC data.

Notes:

[a]Includes staff in the office that administers the Public Utility Holding Company Act of 1935.

[b]The amounts for OCIE present only those staff in SEC's headquarters and regional offices who support or conduct examinations of mutual funds and investment advisers.

[c]The amounts for the Division of Enforcement include all staff in SEC's headquarters and regional that support or conduct enforcement activities over mutual funds, investment advisers, broker-dealers, and all other entities that SEC regulates.

The units responsible for mutual fund oversight benefited from the additional staff they received. For example, OCIE staff said that with the added resources they received in 2003, they were able to begin conducting additional examinations that they hoped would allow them to increase the frequency of the reviews they conduct of the largest fund companies as well as those that pose the greatest compliance risks to as often as every 2 years. OCIE staff said that additional positions requested for 2005 would be used to expand its examination program in the SEC regional offices.

[16]SEC's Division of Enforcement also pursues cases against broker-dealers for abuses involving the sale of mutual fund shares under rules and regulations of the Securities Exchange Act of 1934.

SEC's Chairman also recently testified that he has asked the staff to prepare a rule proposal that would require managers to hedge funds to register with SEC and submit to examinations.[17] OCIE staff said that some of the additional staff SEC requested for 2005 could likely be used to assist with those efforts.

SEC's Enforcement Division has also been able to devote more resources to mutual fund cases. After filing less than 10 cases involving mutual funds in 2003, Enforcement Division staff told us that they had already filed 18 cases involving funds as of March 2004 and currently had about 20 percent of their staff pursuing mutual fund-related matters.

Division of Investment Management officials told us that the 2003 budget increase allowed them to hire additional accountants to review investment company financial statements, as mandated by Sarbanes-Oxley. The officials said that additional resources obtained in 2004 and requested for 2005 will enable the division to increase its reviews of funds' financial statements from 1,134 in 2003, which represents about 10 percent of funds, to 4,800 in 2004, or about 40 percent of all funds.

SEC Allocated Resources Absent a Current Strategic Plan

Although SEC has directed increased resources to oversee mutual funds, these allocation decisions were made without the benefit of an updated strategic plan; thus, it is difficult to determine the extent to which these increases reflect the optimal use of SEC's limited resources. According to GAO guidance on effectively developing and implementing strategic plans, leading organizations recognize that their activities, core processes, and resources must be aligned to support their missions and help them achieve their goals.[18] To achieve this, leading organizations articulate a well-defined mission in their overall strategic plan that forms the foundation for the key business systems and processes they use to ensure the successful outcome of their operations. By aligning activities to support mission-related goals, the organizations are also better able to link the levels of funding for their activities and anticipated results. As a complement to the

[17]See U.S. Securities and Exchange Commission, Chairman William H. Donaldson, *Testimony Before the U.S. Senate Committee on Banking, Housing and Urban Affairs Concerning Investor Protection Issues Regarding the Regulation of the Mutual Fund Industry* (Apr. 8, 2004).

[18]U.S. General Accounting Office, *Executive Guide: Effectively Implementing the Government Performance and Results Act*, GAO/GGD-96-118 (Washington, D.C.: June 1, 1996).

strategic plan, organizations should also determine the specific staff competencies needed to fulfill their mission and develop a human capital plan that addresses how they will acquire, develop, and retain the employees they need.[19]

SEC is in the process of updating its strategic plan but as of April 13, 2004, had not completed this process. Under the Government Performance and Results Act, federal agencies are required to prepare strategic plans that address how they will fulfill their mission over the next 5 years. These strategic plans are required to be updated to reflect current circumstances every 3 years. Since SEC's last plan was prepared in 2000, significant changes in the securities markets and its budgetary resources have occurred. SEC was slated to complete its latest update by September 30, 2003. According to SEC staff, a draft summary of the agency's plan was present to the SEC Chairman in October 2003 but he directed staff to start fresh and not rely on the previous strategic plan. As of April 2004, SEC staff told us that the latest draft of the plan was awaiting approval by the Office of the Chairman and would need to be approved by the other SEC Commissioners.

In recent years, SEC has taken various steps to determine its resource allocations but has done so without an updated strategic plan to guide these decisions. As we reported in 2002, SEC traditionally had not reviewed its staffing and resources in terms of its overall strategic plan.[20] Instead, it generally developed its annual budget request, including requests for additional staff positions, by basing the request on its previous year's appropriation, rather than on the level of resources it actually may need to fulfill its mission.

Although lacking an updated strategic plan, SEC did use an internal study of its operations to guide resource decisions for 2003. The large budget increase resulting from Sarbanes-Oxley provided SEC with an additional 842 positions for fiscal year 2003. To allocate these positions across its various units, SEC drew upon an internal study that analyzed its operations, including workload, resource allocations, methods for assigning and managing work, and measures of performance, productivity,

[19]See U.S. General Accounting Office, *Human Capital: Key Principles for Effective Strategic Workforce Planning*, GAO-04-39 (Washington, D.C.: Dec. 11, 2003) and *A Model of Strategic Human Capital Management*, GAO-02-373SP (Washington, D.C.: Mar. 15, 2002).

[20]GAO-02-302.

and quality of effort. Each SEC division and office also had to provide the SEC Chairman with details of what would be accomplished if additional resources were provided.

To allocate the positions included in the 2004 budget, the various units with responsibility for mutual fund oversight took varying steps to determine their staffing needs. Staff in the Enforcement and Investment Management divisions told us their managers were required to consider priorities and goals for the coming year and then estimate the number of staff needed to complete the activities associated with those goals. Staff in these divisions told us that determining those numbers was difficult because the amount of time required to complete the activities they perform, such as developing rules or investigating cases, can vary widely. In the case of the Enforcement Division, their resulting staffing allocation reflected an estimate of what they believed they could obtain rather than the amount of staff required to investigate all matters they might receive. Moreover, staff told us that it was not possible to determine how much fraud existed within the securities markets and therefore it was difficult to determine what level of resources realistically were needed to ensure enforcement of the federal securities laws. OCIE staff, in contrast, told us that they were better able to estimate workload measures, including the number and types of examinations to be completed and the amount of time required to complete them, in order to determine the number of staff they needed.

In the absence of a complete and updated strategic plan that identifies its key mission-related goals, we were unable to determine whether SEC's recent allocation decisions made the best possible use of its resources. In making these decisions, SEC has obviously increased staffing in key areas, including providing additional resources to develop rules, examine participants, and pursue enforcement actions against abusive practices in the mutual fund industry. However, without a complete and current strategic plan that outlines the agency's priorities, the agency lacks a key guide for ensuring that it is deploying its resources across these areas in the most efficient way to achieve the most effective outcomes.

Some Progress Made in Human Capital Management and Performance Measurement

Although SEC has yet to complete updated strategic and human capital plans, it has made some progress in addressing strategic human capital management and measuring its performance. For example, it has taken steps to improve its recruiting and hiring processes and has implemented an agencywide training program to increase its overall staff competency. Recognizing that retention of staff is important to achieving its mission,

SEC has negotiated an agreement with its new employee union that includes various "worklife" programs such as flextime, flexiplace, and tuition reimbursement as a means for increasing morale and job satisfaction.

SEC also has made progress in developing performance measures that are part of an overall strategic planning framework. To track the performance of its various units, SEC staff recently developed various measures of the activities undertaken within their units that they are calling the "performance dashboard." Although still undergoing revision, these appear to contain key measures of performance for each program area within SEC. SEC staff acknowledged that many of the measures are still output-oriented, but they will likely be useful for improving SEC's effectiveness. For example, Division of Investment Management staff told us that after seeing the "dashboard" reports, they made changes to their procedures that helped them reduce the number of applications for exemptions that were pending for 12 months or more by almost 30 percent. While the development of the dashboard report is promising, we are concerned that creating performance measures before the latest version of the agency's strategic plan is complete may mean that SEC will have to replace some measures with others to be consistent with its newly defined strategic vision.

SEC Faces Agencywide Challenges That Also Affect Mutual Fund Oversight

Although it has received additional resources in recent years, SEC still faces a number of agencywide challenges impacting its mission and its ability to oversee the mutual fund industry. These challenges include improving its ability to head off major problems before they occur by better anticipating and detecting abuses in the securities industry. SEC also faces challenges in hiring and retaining all the staff it needs to achieve its mission as demands on staff continue to grow. Moreover, SEC has experienced difficulties in obtaining the information technology it needs to effectively oversee the mutual funds industry. Finally, SEC faces challenges in overcoming impediments to its ability to gather information, cooperate with other law enforcement authorities, and collect monies owed. Overall, SEC must effectively address these challenges to successfully restore and, in the long-run, maintain investor confidence in our securities markets.

Timely Anticipation and Identification of Problems Is a Challenge

One of the challenges SEC faces is being able to anticipate potential problems and identify the extent to which they exist. Historically, limited resources have forced the SEC to be largely reactive, focusing on the most critical events of the day. In this mode, the agency lacked the institutional structure and capability to systematically anticipate risks and align agencywide resources against those risks. In an environment such as this, it is perhaps not surprising that SEC was not able to identify the widespread misconduct and trading abuses in the mutual fund industry. Increasing SEC's effectiveness would require it to become more proactive by thinking strategically, identifying and prioritizing emerging issues, and marshalling resources from across the organization to answer its most pressing needs.

To improve its ability to better anticipate, identify, and manage emerging risks and market trends that stand to threaten SEC's ability to fulfill its mission, SEC is implementing a centralized risk assessment function within the agency. According to SEC's Chairman, this function will be housed in SEC's newly created Office of Risk Assessment and Strategic Planning, whose duties include:

- gathering and maintaining data on new trends and risks from external experts, domestic and foreign agencies, surveys, focus groups, and other market data;
- analyzing data to identify and assess new areas of concern across professions, companies, industries, and markets; and
- preparing assessments and forecasts on the agency's risk environment.

According to statements by SEC's Chairman, the yet-unstaffed office will work in coordination with staff assigned to conduct risk assessment activities from each division and a Risk Management Committee responsible for reviewing implications of identified risks and recommending an appropriate course of action. The new office is also intended to foster better communication and coordination between divisions and offices within the Commission.

SEC staff in the units with responsibility for mutual funds told us they have begun activities to identify emerging risks within their areas. For example, OCIE officials said that examiners have begun efforts to identify what they believe to be the key risks in their ongoing examinations. With this information, OCIE officials hope to develop a formalized process in which this information would flow up through the office and into the risk

assessment office. Similarly, according to Division of Enforcement officials, the division has reorganized staff in its Office of Chief Counsel by functional lines rather than by geographical location. The functional lines include investment adviser and mutual funds, broker-dealers and markets, and corporate accounting. The intent of this reorganization is to increase the staff's subject matter expertise and better detect emerging issues. Enforcement officials said they have already hired experts in the first two lines to further increase the division's expertise and assist in the agencywide risk analysis project, and have plans to hire a corporate accounting expert soon.

Filling New Positions and Existing Vacancies May Not Address All Needs

SEC continues to face agencywide challenges in hiring and retaining sufficient numbers of quality staff to achieve its mission. With the additional staff positions authorized in 2003 and vacancies and attrition in existing positions, SEC staff indicated that they were faced with hiring over 1,280 people in the last 1 ½ years. Although it has made considerable progress in filling these positions, SEC's Chairman stated in his recent testimony to a House Appropriations subcommittee that SEC still expects to have as many as 425 vacancies by May 2004, which is equal to an 11 percent agencywide vacancy rate.[21] According to the Chairman's statement, about 150 of these vacancies are attorney positions, 120 are accountant positions, and 60 are examiner positions. In addition, by the end of 2005, SEC hopes to receive funding to hire an additional 106 staff, which SEC intends to use to, among other things, further enhance its oversight of mutual funds and to address its market structure reform initiatives.

As we reported to you in July 2003, the competitive service hiring requirements with which SEC was required to comply to hire staff involved the completion of various lengthy processes, such as ranking candidates by position, before filling a vacancy. According to SEC staff, the considerable time required to complete these processes hampered the agency's ability to meet its hiring goals. As a result, the agency asked for and received relief from these requirements under the Accountant, Compliance and Enforcement Staffing Act of 2003, enacted in July 2003

[21]See U.S. Securities and Exchange Commission Chairman William H. Donaldson, *Testimony Before the Subcommittee on Commerce, Justice, State, and the Judiciary, Committee on Appropriations, United States House of Representatives Concerning Fiscal 2005 Appropriations Request for the U. S. Securities and Exchange Commission* (Mar. 31, 2004).

and intended to enable SEC to expedite the hiring of accountants, economists, and examiners. SEC staff told us that bypassing competitive processes has helped them hire individuals for such positions more quickly. In recent testimony, SEC's Chairman noted that the number of vacant positions would have been much higher without this legislation.

In addition, acting under recently granted compensation authority, SEC also implemented a new compensation system, which established a pay structure more comparable to other federal financial regulators. SEC officials stated that the new hiring and compensation authority, along with current economic conditions, has improved the hiring and retention of staff. For example, according to SEC staff, since 2001 the agency's turnover rate dropped from approximately 8 percent in fiscal year 2001 to 1.2 percent in fiscal year 2002 and 1.5 percent in fiscal year 2003. Previously turnover had been as high as almost 14 percent.

The units responsible for mutual fund oversight generally have been making progress in meeting their goals for hiring additional staff, but demands on their staff continue to grow. SEC's Investment Management Division is attempting to reach a staffing level of 190 positions by the end of fiscal year 2004. According to division staff, at midyear they had about 175 staff on board. Of the remaining 15 vacancies, 5 are staff that are designated for public utility holding company oversight. Staff from the Enforcement program, which is attempting to reach 1,248 positions by the end of fiscal year 2004, had about 1,070 on board as of April 2004. However, staff from both these divisions told us that they have had difficulty in recruiting accountants due to competition from the private sector as well as the Public Company Accounting Oversight Board, which they said is able to pay much higher salaries.

Although OCIE has had some success in hiring additional examiners, the revelations of the widespread abuses in the industry has also resulted in an expansion of its workload. OCIE staff told us that in trying to reach their mutual fund-related staffing goals for the end of fiscal year 2004, only about 3 percent of their positions were vacant as of March 2004, primarily as a result of attrition. However, OCIE staff also told us that as a result of the mutual fund abuses, examiners will be conducting more comprehensive examinations and more targeted mini-sweeps, which are focused examinations that deal with just a single issue across a number of firms. For example, to aid in detecting any misconduct that might not otherwise be reflected in the books and records kept by a firm and shown to examiners, OCIE staff said that their routine examinations would now include a review of a sample of fund executives' internal e-mail

communications. Other new examination steps OCIE said they were implementing include reviewing personal trading records that show fund executives trading in their funds' shares and reviews of procedures to ensure that fund share orders are processed to receive the appropriate day's net asset value, including firms' procedures governing order receipt time and order time stamping.

Given these additional activities, OCIE staff said that the time required to complete an examination has increased dramatically and threatens their ability to meet the newly established goals for increased examination frequency. With the additional resources added to the examination program in 2003, SEC was able to increase examination frequency of the largest fund firms and of those posing the greatest compliance risk from once every 5 years to once every 2 years. As noted previously, SEC's examinations of some mutual fund companies had been as infrequent as once every 12-24 years during the 1990s. OCIE staff said that they are currently considering ways in which they could save time as well as maximize coverage of the industry, but they are not yet in a position to provide assurances that they have sufficient resources to both increase the frequency of examinations and conduct more in-depth reviews and mini-sweeps at their currently projected resource levels.

Staff in both OCIE and the Investment Management Division also told us that they will face additional demands on their time in the event that SEC requires hedge fund advisers to register with the agency, which SEC's Chairman has publicly stated he intends to propose. Potentially SEC staff might have to conduct additional regulatory filing reviews and examinations. The amount of additional effort required to oversee hedge fund advisers is not currently known, but Investment Management staff told us that they estimate that between 600 and 1,100 additional advisers would be required to register with SEC.

Obtaining and Effectively Using Information Technology Also a Challenge

Having traditionally lacked sufficient funding for information technology, SEC is in the process of implementing various agencywide initiatives, and the units responsible for mutual funds also have identified projects that could further improve their efficiency. Like the rest of the government, SEC's needs in the area of information technology continue to increase, but SEC recently received authorizations for additional funding to address its needs. As we reported in July 2003, SEC's fiscal year 2003 information technology budget increased more than 100 percent, from around $44 million to $100 million, which allowed SEC to begin funding a number of

agencywide, long-term technology projects. Many of these major initiatives are still in process. These projects include

- Implementing a document management and imaging initiative, intended to eventually eliminate paper documents and allow SEC staff to review and electronically file the large volumes of information that are part of litigation, examination, and enforcement activities. Staff told us that the planned system will provide an agencywide electronic capture, search, and retrieval mechanism for all investigative and examination materials.
- Converting SEC's Electronic Data Gathering Analysis and Retrieval (EDGAR) system into a searchable database that would help SEC conduct various types of industry and trend analyses. EDGAR is the database system that public companies use to file registration statements, periodic reports, and other forms electronically. Currently, EDGAR receives and archives data, but staff cannot immediately and easily analyze it. The goal is to create filings that will allow anyone to extract relevant data.
- Implementing a disaster recovery program that is being designed to store and move large amounts of data among regional or district offices without first going through Washington, D.C. The current project, when completed, will allow the agency to back up critical information and data on a daily basis at multiple locations.

In addition to these agencywide initiatives, staff in the units responsible for mutual fund oversight have identified a number of other technology projects that could help to improve the efficiency of their operations. For example, OCIE officials told us that they would like to provide audit guidance in an electronic format for examination staff, and create Web site links for staff to use in accessing information useful in an examination. They said that having these capabilities would likely reduce the time required to complete examinations.

OCIE officials also stated that they are considering a longer-term project involving the development of a mutual fund surveillance program. On March 5, 2004, the SEC Chairman announced the formation of an internal task force to draft the outlines of this new surveillance program. This group will examine the mutual fund reporting regime and consider changes to both the frequency of reporting to the Commission and the categories of information to be reported, as well as how new technologies can be used to enhance SEC's oversight responsibilities. OCIE's director stated that the goal of such a surveillance program would be to identify indications of problems, and then target the particular fund or adviser for

a follow-up inquiry. With such information, SEC staff would also likely be able to examine relevant data on an industrywide basis to determine if a systemic problem was emerging. Implementation of such an initiative will require a continued commitment to enhancing SEC's information technology capabilities.

Additionally, Investment Management officials said that they have started a project designed to allow investment companies to submit more of their required filings electronically. Their staff are evaluating available technology that will allow them to identify and analyze the data they receive more readily. Currently, most of the filings come in as pure text files and thus are not very well suited for quick quantitative analysis. Officials in the Division of Enforcement said that recent upgrades to their computers have been helpful. We also spoke with an official in SEC's Office of Investor Education and Assistance, which is responsible for analyzing investor complaints, responding to inquiries, and providing educational materials on numerous investing topics, including mutual funds. This official also told us about a number of technology projects that could improve staff operational efficiency. For example, according to the official, the office could benefit from data imaging and retrieval technology for inquiries and complaints that come in a paper format, as the technology would allow staff to access this information by topic or complainant. The official did note that one project, a database that catalogs complaints from the Internet, is currently being implemented.

In addition to the agency's ongoing document management and imaging initiative, SEC staff told us that additional efficiencies could be gained from an improved case tracking system and having greater ability to analyze data to look for trends taking place in the securities industry, particularly in the mutual fund area. Moreover, all of the SEC officials with whom we spoke agreed that the high costs associated with new technologies coupled with a limited information technology budget created a challenge for SEC in meeting its information technology needs.

Investigation and Collection Difficulties Also Hamper SEC's Regulatory Efficiency

SEC also faces challenges that affect its ability to investigate violations and to collect monetary fines and disgorgements that violators are ordered to pay, a process integral to effective oversight.[22] Investigations of securities law violations can be labor intensive, complex, and sometimes require SEC staff to coordinate with staff from other law enforcement or regulatory authorities as has occurred in many of the mutual fund cases that SEC has brought recently. In addition, according to SEC staff, collecting the amounts that violators are ordered to pay can be time consuming and difficult.

SEC's staff has identified various issues that they believe hamper their efficiency in conducting enforcement and collections activities, including investigations involving mutual funds. At a February 2003 congressional hearing, the director of SEC's Enforcement Division testified that under existing criminal procedure law, SEC staff generally are not allowed access to grand jury information. In such cases SEC staff must conduct a separate, duplicative investigation to obtain the same information already in the hands of federal criminal authorities. In some cases, involving mutual funds, state law enforcement authorities convened grand juries.

SEC's ability to protect privileged information also remains in question, hampering its ability to collect such material. In a report mandated by the Sarbanes-Oxley Act, SEC staff noted that their investigative efforts are less efficient and effective at times because the parties under investigation have a disincentive to provide privileged or protected information to SEC. By disclosing such information to SEC, the parties risk that others, such as an adversary in private litigation, could argue that the disclosure waives the protection of that information. SEC staff would like to be able to ensure that these parties can maintain protection over such information after a disclosure to SEC.

The need for SEC staff to make lengthy and complicated efforts to collect fines or disgorgements also prevent them from investigating other matters. As a result, SEC staff indicated their efficiency would be improved if they had authority to contract with private attorneys to undertake litigation to enforce collection orders. The House is considering a bill introduced in

[22]Fines are amounts violators are ordered to pay as punishment for violating the securities laws. Disgorgement is the process by which a violator is ordered to return money obtained as a result of a violation of these laws.

2003 that would give SEC authority to obtain these contracts, as well as other enhancements to the authority of SEC Enforcement staff.[23]

This concludes my prepared statement. I would be happy to respond to questions.

Contacts and Acknowledgements

For further information regarding this testimony, please contact Cody J. Goebel at (202) 512-8678. Individuals making key contributions to this testimony include Toayoa Aldridge, James Lawrence, and David Tarosky.

[23]These additional authorities are included as part of the Securities Fraud Deterrence and Investor Restitution Act of 2003, H.R. 2179.

GAO's Mission

The General Accounting Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through the Internet. GAO's Web site (www.gao.gov) contains abstracts and full-text files of current reports and testimony and an expanding archive of older products. The Web site features a search engine to help you locate documents using key words and phrases. You can print these documents in their entirety, including charts and other graphics.

Each day, GAO issues a list of newly released reports, testimony, and correspondence. GAO posts this list, known as "Today's Reports," on its Web site daily. The list contains links to the full-text document files. To have GAO e-mail this list to you every afternoon, go to www.gao.gov and select "Subscribe to e-mail alerts" under the "Order GAO Products" heading.

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. General Accounting Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone:	Voice:	(202) 512-6000
	TDD:	(202) 512-2537
	Fax:	(202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Public Affairs

Jeff Nelligan, Managing Director, NelliganJ@gao.gov (202) 512-4800
U.S. General Accounting Office, 441 G Street NW, Room 7149
Washington, D.C. 20548

PRINTED ON RECYCLED PAPER

Mr. PLATTS. Thank you, Mr. Hillman. And again thanks for not just being here today, but your work week in and week out in your job at GAO especially as it relates to this subcommittee's focus on the SEC and strategic planning.

Mr. McConnell, I would like to know on the strategic plan, where we are? Soon to be approved and current, what timeframe are we talking about? A week or two or a month, and obviously we are interested to see the plan and have an idea of the Commission's strategy going forward?

Mr. MCCONNELL. Well, we're nearly finished, and we appreciate the indulgence of the subcommittee during this process. We talked with you about it last summer and we have discussed with you throughout the process, and it has been a long process and we appreciate that.

The plan right now is in the chairman's office for final review before going to the Commission. Then it must go through a vote. It must be voted on by the five members. That will be done seriatim, which takes several weeks. So I'm hoping that next month is what we are looking at to get it to you. And then we will hope to get your feedback, because no one has really seen it.

And this process was not simply just updating our previous strategic plan. As Chairman Donaldson said when he viewed the first plan, "This is a nice job but it is not my job." His strategic planning ideas were substantially different. So we essentially went back to scratch in developing this plan. And the process we used was actually, it's a major institutional change and that institutional change is on going and it is tied up with the risk assessment, the organizational reviews. So all of that was being done at the same time. And I think the synergy that was created has helped all of those efforts.

So, hopefully in a month.

Mr. PLATTS. We are hoping, too.

Mr. MCCONNELL. Yes, sir.

Mr. PLATTS. As we did talk last summer, and then we were talking in the fall, by the end of the year. We are now in April, and we are talking May. And it is not just kind of an issue over and over, but as chairman and Mr. Towns, and both sides' staff share the view of GAO, every month's delay just means more decisions that you need to make. And we acknowledge that you cannot sit back and not anything while you are putting this together.

Mr. MCCONNELL. Right.

Mr. PLATTS. But the delay in that strategic plan being finalized, means you are having to make daily decisions and allocations of resources and hiring decisions that are not fully based on the big picture but on a more piecemeal approach.

Mr. MCCONNELL. Yes.

Mr. PLATTS. And we need to get to that big picture. So we certainly hope—and I say that recognizing I always believe it is better to do a thorough and deliberate job and have a good product than to rush something and have a product that you really don't use. So by your being thorough and deliberate, hopefully that means all the more embraced the final will be and the better it will guide the Commission and all the staff.

In your comment you said one thing that relates to my followup questions, you said you are anxious to share with us and GAO, and I believe that because no one has really seen it.

Mr. MCCONNELL. That is correct.

Mr. PLATTS. What type of outreach has the Commission engaged in to GAO, to individuals in the industry, to academia to generate feedback in the drafting of it?

Mr. MCCONNELL. Right.

Mr. PLATTS. I understand that there has been extensive dialog within the Commission, with the staff, but how about outside the SEC?

Mr. MCCONNELL. There has a major outreach effort. And it has been associated also with our risk assessment effort. We have called in people with everything from a brown bag lunch to sort of talking about what is keeping you awake at night——

Mr. PLATTS. People from outside the agency?

Mr. MCCONNELL. From outside the agency, yes.

Mr. PLATTS. OK.

Mr. MCCONNELL. And Mr. Bogle has been one of them.

Mr. PLATTS. Right.

Mr. MCCONNELL. And we will continue to do that to going to the industry, and to the groups that represent major portions of the industry. We have had a lot of interactions with the industry.

It has been in the mode of really gathering information at this point. Of course, in the dialog that occurs they understand the directions we're proceeding, so you get that kind of interaction; that is good. And we are, frankly, we are eager to see what your coments are, we want a lot of comments coming back because this is a new document. It has not been seen before. And we are eager for the comments from this subcommittee and from our stakeholders as to how it has all been put together. And we think the process has been good. We think what we put together is quite good, but let's get the very hard reaction.

Mr. PLATTS. And I appreciate you wanting that feedback, but I want to make sure what you are going to release and vote on is the final strategic plan?

Mr. MCCONNELL. That is correct. It is final.

Mr. PLATTS. And so in a sense it seems that at that point you will get feedback but on a final plan as opposed to a draft. And I am glad to hear Mr. Bogle and others have been included.

How close are you with GAO? I know there is a good interaction there, and I appreciate your comment up front that you are grateful for that interaction, but on the specifics of the plan what efforts have been taken by SEC with GAO?

Mr. MCCONNELL. Well, I will let Rick speak for himself, but we have shared a good bit with GAO in the process in all of these efforts. And I think he has seen some draft executive summaries, as I recall.

Mr. HILLMAN. Yes. We have been given a draft outline of their strategic plan which tends to outline the broad goals of the organization and all the relevant information about how they intend to achieve them. And that is consistent with the activity that we have had with the departments and agencies across the Federal Government in that regard.

Mr. McCONNELL. OK. One thing I would like to add is that the chairman does not view this at all as a 5-year plan, to drop it run. I mean, he thinks this is going to be updated and it is a year-to-year process. And, of course, we report on it yearly and there is a rigorous requirement associated with how you follow through on these plans.

Mr. PLATTS. Hand-in-hand with the strategic plan is the resource management. Your strategic plan is going to help allocate where you put the resources including your human capital, but it is also that you need to have it there.

Mr. McCONNELL. Correct.

Mr. PLATTS. You mentioned in your testimony another 107 by the end of June. Those are people in the pipeline?

Mr. McCONNELL. We actually have names associated with people who have agreed, who have made commitments to come on. So those are hard numbers.

Mr. PLATTS. And then about 403, about almost three times the norm that will still be vacant?

Mr. McCONNELL. That is correct.

Mr. PLATTS. Is there a timeframe for when you think you would get to that 150 benchmark, you know——

Mr. McCONNELL. The end of the fiscal year is when we intend to achieve that target level. And you are right, there will be 150 vacancies probably at the end of the year. That is right. We build that into our plans, that is part of our budgeting, our FTE costs are associated with that kind of a vancany rate.

Mr. PLATTS. Is there a concern with another 250 by September 30th, roughly, so in the final 3 months of the fiscal year? You said some feedback of—I mean that might be wishful thinking just because we appreciate your being thorough and wanting not to just fill seats but to get good people in those slots.

Mr. McCONNELL. Yes.

Mr. PLATTS. And that there is such competition because of Sarbanes-Oxley and what the industry is demanding to be——

Mr. McCONNELL. Right.

Mr. PLATTS. Are you pretty certain or is it, you know, what your goal is but how realistic a goal?

Mr. McCONNELL. We think it is realistic. We have actually—the competition you are talking about mainly deals with accountants and that is where the Sarbanes-Oxley competition occurs and where the competition with the PCAOB and with ever major public accounting firm in the country. You are all hiring accountants and many are the same ones that we are hiring. But we have, I think there are about 27 percent left, to hear.

We have been using the services of an outside selection firm for that. The pipeline has gotten pretty good. We have a good size pipeline now of quality applications, and we have instituted procedures in place where we are bringing on 30, 40, 50 a month. So I think we will make it.

Attorneys, we have had the competition. That has been more of an accommodation on our part; how quickly and how effective we can bring them in, bring them in to new places, into new areas and how to build the organization properly.

Mr. PLATTS. Right.

Mr. McCONNELL. And we have never really had problems with attracting attorneys.

Examiners, similarly. We have not had problems attracting examiners. We are pretty well fully staffed up in that area. And there we are just dealing with sort of normal attrition.

Mr. PLATTS. Well, and I do appreciate and I am sure Chairman Davis appreciates the way you have embraced the additional flexibility in the human capital side to retain and recruit and using the resources being given to you effectively. You're probably making a case for that type of flexibility elsewhere in the Federal Government as well. I am sure we and others will be watching that process.

Mr. McCONNELL. We have lots of attention. Lots of attention.

Mr. PLATTS. I yield to Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman.

Mr. Hillman, the SEC seems to be having difficulty attracting, as we just finished talking about, talented and adequately skilled individuals for professional staff. And, of course, Congress as we have talked about here, we increased the agency flexibility in hiring and setting pay. Is this enough to attract the necessary qualified staff do you believe? Do you think this is adequate?

Mr. HILLMAN. One of the major impediments, as Mr. McConnell just described, is their inability to really bring on topnotch accountants into the organization. And Congress has provided relief to the SEC last summer to better position themselves to complete their recruitment process in a more expeditious fashion so that they can attract and obtain quality accountants. And that is a problem the SEC will continue to face because really, in the Washington, DC, area with the Public Company Accounting Oversight Board also attempting to attract accountants to fill their ranks, and with these major big four CPA firms changing over as a result of the financial scandals, doing more detailed audits of new clients, they're clamoring for additional accountants as well. It is just a vicious market out there right and SEC is trying to complete the best that they can.

Mr. TOWNS. Right. But is it not also a problem of retaining as well? They say if you recruit one, you hire one and another leaves; and then at the end of the day you are at the same level. So I am thinking that maybe you might want to become creative by saying that after 3 years, after 5 years of being employed by this agency, a bonus of some sort would be given.

I mean, you cannot continue to do business as usual expecting a different result.

Mr. HILLMAN. Very interesting insight.

Mr. McCONNELL. You are absolutely right. And creativity is needed in a lot of front, and we are adding benefits and we are looking at various ways to maximize the authorities that we have been given. And we are also looking at a different way to deal with the work force.

Perhaps all of these accountants do not need to be in Washington. There is lots of technology that's on the cusp or already here that would allow us to have, perhaps, remote locations where there probably is not this cutthroat competition for accountants.

So we appreciate that concern. It is on our minds a lot, and you are right there are creative things that have to be done, and this chairman is prepared to do them.

Mr. TOWNS. Right. I thank you.

Mr. Hillman, can you cite for us any specific area that SEC is lacking legal authority to adequately pursue mutual fund industry investigations or general oversight? Is there any area that you feel that the Congress should look at to see in terms of what changes to be made in order to make it possible for them to carry out their mission?

Mr. HILLMAN. We have looked at this issue, and our Comptroller General has testified before the Senate Banking Committee on March 10th that many of the actions that need to be addressed to cover the abuses that have occurred in the mutual fund industry SEC is well positioned to do. But there are a couple of areas. In particular looking at an issue referred to as "soft dollars" in the mutual fund industries where commissions that investors pay to buy and sell their shares, more visibility associated with what those commissions are paying for we think are needed.

The soft dollar issue refers to a practice where these commissions not only pay for the trades that occur, according to investors' wishes, but also research and other services are being provided to the fund. We in the General Accounting Office believe that there is not adequate disclosure of those additional costs associated with research and other services that are being provided, and in some instances that is going to require Congress to step in and evaluate what is referred to as a safe harbor that Congress established in ensuring that the commissions and these research services are being provided.

Mr. TOWNS. All right. Thank you.

Let me just make certain, Mr. McConnell, that I understand how this process works in terms of the plan. Are you saying that you send the plan out, you know, to the various Commissioners and then they look at it and vote on it? I mean, is that——

Mr. MCCONNELL. That is correct. They have to vote on it. It's a Commission vote.

Mr. TOWNS. I understand that, but I mean it is not a situation where there is a meeting and that each member votes at a time, rather then you send it to Chicago, you send it—I mean, I want to make sure that I understand that process.

Mr. MCCONNELL. Yes, sir.

All the Commissioners, it's just the five Commissioners that have to vote. They are all in Washington.

Mr. TOWNS. I understand that.

Mr. MCCONNELL. So we will probably not convene a meeting where the plan is presented and they vote at one time. It is a process we use quite frequently for reports, official Commission documents and rulemakings where each Commissioner's office is provided the entire document and background, are giving briefings as they want for the process. They deliberate and then they vote by just signing a document saying my vote is in the affirmative or this release.

There are two basic processes for making SEC actions. One is an open meeting where they all sit at a dias and actually vote there,

or this other more deliberative—it is a slower process, frankly, but it is our seriatim process.

Mr. TOWNS. It would seem to me—I mean here again I guess this is on another subject. But it would seem to me something as important as this that they would all come together in the same room and vote and make a decision, you know. I just sort of problems in terms of my own mind——

Mr. MCCONNELL. Yes.

Mr. TOWNS [continuing]. That it would be done, you know, and I hate to use the word "haphazard" but I must say that I just have problems with them not coming and doing this and having dialog and then fashion their vote on an issue as important, and one that we waited so long to receive.

Mr. MCCONNELL. I do not want to give the subcommittee the opinion that the one process is any less deliberative or important than the other. I mean, clearly the seriatim process is used for some of the most important actions the Commission takes. It just really depends on the way the chairman wants to do it, schedules of the other Commissioners and it is the process that they want to choose.

Any Commissioner, at anytime can call for a meeting if they do not choose to use the seriatim process. But they generally like to do it this way. It allows them more time for review, it is going to be over 70 pages, plus a lot of background and they will go through it, their staffs will go through it, I will get called into their office, Peter Derby will get called into their office to explain things. So it allows for a lot of iterations.

Mr. TOWNS. Yes.

Mr. MCCONNELL. And explanation.

Mr. TOWNS. Yes. I understand all that, but I just think that something of this magnitude, you know—but anyway, I mean that is——

Mr. MCCONNELL. I will let them know that.

Mr. TOWNS. Yes, please do.

Mr. MCCONNELL. I will certainly express your concerns with Chairman Donaldson.

Mr. TOWNS. Yes, especially I mean it would seem to me it would be a situation where you would come together.

Mr. MCCONNELL. Right.

Mr. TOWNS. And there would be dialog and then you pass it on.

I think the question was raised earlier in terms of who did you talk to sort of outside to be able to work, get information input for the plan. I asked the Attorney General did you talk to him, and of course he sort of did not quite give me a straight answer on that one. But I want to know who did you talk to on the outside world, you know, people that were former Commissioners or actually in terms of—even chief of staffs did you talk to. I mean, in terms of putting together this plan?

Mr. MCCONNELL. Well, there has been—I mean, I could probably give you the actual lists at some point, but I will give you a general idea.

Mr. TOWNS. Just a general idea. You do not have to——

Mr. MCCONNELL. There has been a lot of interaction, and it has included the former staff members, former members of the Com-

mission, and then those groups; the ABA, you know, those groups that you traditionally go to that either represent segments of the industry or segments of the bar. And then we have called in people on sort of an informal basis where it is off the record; let us have lunch, sit around with four or five people and talk about things like just what is on your mind, what is troubling you, what keeps you awake at night with respect to the industry. And trying to get as much of that in a really non-threatening environment.

We always have to appreciate that everybody has an agenda at times, but gathering that kind of information and having open discussions. And that way sort of get an idea as to where we are going and we get an idea as to what they see are problems we should be addressing. And that is a lot of people from all across, and that is an ongoing effort. And we are building that into our risk assessment, the strategic planning office will keep undertaking that.

And academics. I mean, we have a strong academic program in our office of economic analyses. And they call in academic and review papers. We need to do more of it. And our notion is we have to do better at anticipating, at being proactive. We do not really disagree, I do not think, with almost anything that has been said during this hearing in terms of that need.

Mr. TOWNS. Do you have the technology to address these issues?

Mr. MCCONNELL. We are getting the technology. As you know, we have had a major increase in our technology budget. It went from $40 million to over $100 dollars.

Talk about a tough time hiring somebody, we had a really hard time getting a CIO. That person came on board in January. He is putting together the strategic plan review. We have a number of major efforts already underway however. With document management, we have an initiative to enhance substantially our disclosure program, to take advantage of technology, data tagging to make it easier for both our staff and mainly investors to understand what is in these documents that are filed with the SEC.

Our enterprise architecture is being examined and our security. Our security program.

Mr. TOWNS. I yield back to the chairman.

Thank you.

Mr. PLATTS. Thank you, Mr. Towns.

I want to followup on the plan approval process. And while it is a requirement under GPRA not just for SEC, but other departments and agencies also. It is a little different here because you're a regulatory agency.

Mr. MCCONNELL. Right.

Mr. PLATTS. And with a board of five that do actually vote on approval of this. This is different than a department, where there is not that formal public vote and approval.

Given that, and this is kind of expanding on Mr. Towns' and my questioning—in some ways it seems that this should be a different process where while you have had a lot of input from outside the Commission, it is from those who you have invited input from as opposed to, perhaps, some who would like to provide input but were not invited. It seems like analogous to a local municipal authority or a local municipality having a plan that we are going to take a formal vote on and we are going to have a public hearing

on it so it is out there publicly before the vote so that all who want to have input in writing, you know, or in person can have some input, not just those who you invited. Was that something that was considered by the Commissio—to actually share this in a public sense prior to the vote to generate feedback?

Mr. McCONNELL. Not to my—no, it has not been.

Mr. PLATTS. And on the one hand I would like to urge that, but I know that if I urge it it also would delay it longer. And at this point I am not sure what is the best approach. I think getting done and then we can always—but, you know, it is something that given that is a 5-year with doing an annual approach——

Mr. McCONNELL. Right.

Mr. PLATTS. And it is a work in progress that hopefully will always be a work in progress to adjust to the mark that is different challenges. I think that is something that is considered perhaps in the future.

I also, though, as far as approving it, a simple majority; three out of the five approves the plan?

Mr. McCONNELL. Yes. Right.

Mr. PLATTS. OK. It is just a different setting than a typical agency.

Mr. McCONNELL. It is.

Mr. PLATTS. In the fact that there is a public vote. And coming out of the State house, under State law you would be required to have a hearing and allow public input before you could vote.

Mr. McCONNELL. I will certainly take your concerns back to the chairman.

Mr. PLATTS. Yes. Because I appreciate you seeking the input, but sometimes human nature is we seek input from those who have close relationship with.

Mr. McCONNELL. Right.

Mr. PLATTS. And not get input from others who maybe we do not have a close relationship with, but would bring some valuable knowledge to the table.

Mr. McCONNELL. Understand. Sunshine and full disclosure is what we are about.

Mr. PLATTS. Yes.

One of the recommendations of Mr. Bogle is the kind of comprehensive economic study of mutual funds. And the mutual fund, while it is not the focus of this hearing, it is kind of a case study of——

Mr. McCONNELL. Right.

Mr. PLATTS [continuing]. The importance of resource management and why we kind of push for the strategic plan and that big picture approach.

What would be your thoughts on the approach Mr. Bogle suggested?

Mr. McCONNELL. Well, I cannot comment on that specific approach as something that maybe the Commission would adopt or not adopt. But we are certainly envisioning that type of activity as part of this office of risk assessment and strategic planning.

The office itself will be constructed or consist of five people; a director and four or five key staff, some of whom may be academics come in on loan. They will also have the resources available to un-

dertake major studies. That could be one of them. I cannot speak for the Commissioners as to whether it would be or not. But it certainly that type of activity is envisioned in this approach.

Mr. PLATTS. And I think it helpful with your hearing not just from Mr. Bogle and his push——

Mr. MCCONNELL. Right.

Mr. PLATTS [continuing]. But hearing from the other side, the Attorney General, somebody who has been regulated as well as law enforcement. I would hope that it is something that is given close scrutiny——

Mr. MCCONNELL. As a private citizen it sounds like a pretty good idea. Again, that is——

Mr. PLATTS. And continuing on the allocation issue regarding mutual funds and, Mr. Hillman, you certainly have watched this closely and with the reorganization, although we have seen reorganizations prior to the strategic plan being completed based on the necessity of a new board and put more manpower into the mutual fund oversight, what is GAO's assessment at this point of resources that have been allocated? Do you believe they are sufficient and you are going to be able to meet the challenge that come forward through the Attorney General and other efforts?

Mr. HILLMAN. We think that the allocations the SEC has made are certainly consistent with what the Sarbanes-Oxley Act required it to do in ratching up the oversight attention to filings that come in from corporation to make sure there are not continuation of scandals and corporate accounting problems. And the ratching up of the enforcement division and their office of examination are all certainly components that they need to provide attention to.

I guess from the General Accounting Office's standpoint, what we are looking for and hoping to see is some assurances from the strategic planning process and a human capital planning process that SEC indeed does have all the resources that it believes it needs in order to effectively oversee the securities industry. What we have seen so far to date is that resources that Congress has been able to provide it equated to about 842 positions. They are asking in their recent request for fiscal year 2005 an additional 106 positions.

What we are hoping to see is that there is some sort of an analysis to say with these resources we feel we are going to be able to be out in front as to what these issues are expecting to be over the next 5 years, and effective would be able to be proactive as opposed to reactive.

Over the years SEC has not had the resources it has needed to oversee the industry, and as a result has had to perhaps call back upon some of its goals it has had out there. For example, in the recent issue with Sarbanes-Oxley, SEC has not been able to review all the filings that it needs to review on a timely basis and as a result, it had not reviewed the filings that had come in from Enron and Global Crossing to be able to detect and deter these types of activities.

And with these additional resources now Congress made it in law a requirement that they review all filings over a 3-year period of time. Well, 5 years hence that was an SEC goal, but they were not able to achieve that because of resource limitations.

Bringing it back up to date here in the mutual fund industry, you are looking at the Office of Examinations. They have come up with what we believe seems to be a very realistic target of looking at the top mutual fund complexes or on a more frequent level, perhaps every couple of years and ensuring that all complexes overall get looked at over a 4-year basis.

With this mutual fund industry crises and the scandals that have occurred, though, however there are now additional examination steps that must be performed in order to ensure that the industry is safe. The director of that office is concerned at the moment as to whether or not they have enough resources to do all that they need to do to oversee these fund complexes with these now additional responsibilities that are being placed on them and each of their routine examinations.

We would like the SEC to be able to say OK, in order to do what it needs to do, these are the resources that it needs and to let Congress decide if they cannot fund those because of other competing priorities in the Nation, to make that known. But at this moment without a strategic plan, without an analyses review and capital planning standpoint of their expertise and resource levels, it is difficult to say to what extent they are able to achieve their goals.

Mr. PLATTS. We are kind of assuming from us outside the Commission that request for 100 plus more in the 2005 budget request fits in to what the Commission envisioned approving its strategic plan. We have not seen it, we do not know that. I assume once we see it, it will maybe jive, you know, that we need additional positions and here is why. I mean, that is kind of what you are getting at this point we are making that assumption and thinking as a given that additional requests are going to match up with their vision in that strategic plan, but we really do not know that.

It really goes to—what you touched on—that the SEC actually envisioned doing those regular reviews, but did not have the resources. And I do not have a base knowledge myself in the 1990's coming into office in 2001, what was the message coming from this. Publicly, Congress at large, you know we kind of looked at the SEC as a rainmaker because it was generating billions of fees and getting a smaller and smaller percentage. Were the SEC Commissioners, the chairman, you know, crying uncle and saying hey, you know, we are getting overwhelmed and Congress was ignoring it or was it just an acceptance and hey, this is what we do and this is the way to do it.

Mr. MCCONNELL. Well, I think we certainly are bringing the attention to whomever we could that the mutual fund industry was growing dramatically and needed fundamental changes. Some fundamental changes did occur. I mean, we changed the whole regulatory scheme back in the 1990's so that the small investment advisers that were not holding assets were no longer under our review. I mean, we knew we simply could not do it, so we changed the population and changed the regulatory scheme by which—so that was one major effort. We thought by doing that we would be able to get back to a more—and at that time we had, I think as Mr. Hillman indicated, a review cycle of 20 or 30 years if you just divided it up and the number staff we had. And we have always wanted to get back to somewhere a 2 or 4 or 5 year process, de-

pending on risk associated with that. So we thought we had that worked out, but things continued to grow and it is just that we are constantly playing catch up.

The last few years——

Mr. PLATTS. The worry is that you are playing catch up.

Mr. MCCONNELL. Right.

Mr. PLATTS. Is that now we are playing catch up to the mutual fund issue. You know, Sarbanes-Oxley has been enforced. We already play catch up on a corporate governance, on disclosure. Two years from now I am hoping that we are not going to be saying now we are playing catch up on something else that came forward because we were not proactive.

Mr. MCCONNELL. Right.

Mr. PLATTS. We are continuing to be reactive.

Mr. MCCONNELL. I cannot judge that we will have the resources, but this chairman is guaranteeing that he is going to let people know what we need. And that is what this is all about.

Mr. PLATTS. And that is exactly what I mean. It is important that——

Mr. MCCONNELL. That is right. That is what this all about.

Mr. PLATTS. And, you know, soft peddling.

Mr. MCCONNELL. And if we do not get the resources, everybody knows it and it is the decision that has been made.

Mr. PLATTS. Here is what we need to do and here is what we need to be able to do that.

Mr. MCCONNELL. Exactly.

Mr. PLATTS. And then if Congress does not deliver, the onus is on us.

Mr. MCCONNELL. Congress has to make the choices.

Mr. PLATTS. Yes. Correct.

Actually, Mr. Towns, do you have any questions?

Mr. TOWNS. No. I am fine.

Mr. PLATTS. OK. On the office of risk assessment program, you made the accommodation and come to the internal themes. Again, what type timeframe are you envisioning there? Again, in the next month or two? Is that in the next fiscal year?

Mr. MCCONNELL. The whole risk assessment program that we are putting in place has three major components, one of which are these risk assessment teams that are basically—we started those.

Mr. PLATTS. Right.

Mr. MCCONNELL. They are in operation.

Mr. PLATTS. And so they are doing risk—now.

Mr. MCCONNELL. They are risk mapping through the entire agency on a program-by-program basis.

Mr. PLATTS. OK.

Mr. MCCONNELL. Building through the raw data.

We also have part of it as embedded risk assessment staff in each of the divisions and major offices. That is underway. Those people are being hired. They will be in the division but have a dual reporting capacity. The key is to get this final five person office set up and then it all comes together. That we are still struggling with finding the right person to be the director. That has been a challenge.

We have been close a few times with some people. The kind of people we are looking at for that job make a lot of money. And they are highly sought out by lots of people, lots of organizations. And we think we have a very attractive——

Mr. PLATTS. Did you mention it to Bogle today that you have that—he seems like he would be a pretty good match.

Mr. MCCONNELL. Maybe so. We will talk to him afterward. But those are the kinds of people——

Mr. PLATTS. Yes. And you made it through that. Is the use of that more than doubling the technology, can you tell us how you are looking at using data mining, you know technology to compliment the human capital, to really stretch the human capital farther through technology?

Mr. MCCONNELL. We are really excited about those possibilities. Because, I mean, that is the way in which you make your resources that you have work, especially in an information rich industry like we have. I mean, there is just lots and lots of available information.

We are starting some initiatives. We are starting two underway now, one of which deals with mutual funds, not surprisingly, we want to start getting a handle on that. And the other is on full disclosure data, some more information on data ragging.

But we have brought in a whole new data base search engine, autonomy, that we hope to be able to maximize so that we have data from all different sources; from enforcement cases, from you know appropriate dealers and investment advisers have data on people and firms that we could mind, so we want to be there. I think we see the promise and the future of that.

Mr. PLATTS. And your comment on the risk assessment office, the idea of bringing academics in and Dr. Morey is not here to defend himself, but——

Mr. MCCONNELL. He can sign up, too, is that what you are saying?

Mr. PLATTS. Well, but I was going to say also because sometimes in the outside academic world because you are focused on the day-to-day, just keeping everything in place—you do not have the time to sit back and take anymore analytical assessment.

Mr. MCCONNELL. That is right.

Mr. PLATTS. And the academic communities can do that. His study on the window dressing issues for instance——

Mr. MCCONNELL. Right.

Mr. PLATTS [continuing]. It is kind of like the type of thing the SEC should be doing.

Mr. MCCONNELL. Yes.

Mr. PLATTS. And you mentioned that you are looking including some of the academic community, perhaps visiting members of that office on loan or something——

Mr. MCCONNELL. That is correct.

Mr. PLATTS. I think it could be helpful.

What type of outreach and specifically using the example of the window dressing, you know he referenced there has not been one formal investigation done. Given what he is showing, it seems that there would be a natural reaction that this is not a scandal but something that has been put on our plate, our radar that we need

to look at. But unless I am not aware of it, there has not been any followup by the Commission on that specific issue.

Mr. MCCONNELL. I am not aware of any either. I will certainly check with the enforcement division. But whether they do it or not——

Mr. PLATTS. And again when I to talk to the reporter about today's hearing it comes back around to the importance of the strategic plan because——

Mr. MCCONNELL. That is right.

Mr. PLATTS [continuing]. To do that it has to be not a piecemeal decision again, but what are our total resources.

Mr. MCCONNELL. Exactly.

Mr. PLATTS. So what can we put on that type of administration. And it really goes back to the importance of that big picture being enclosed.

Mr. MCCONNELL. That is one of the risks that you put on the table with all the other risks.

Mr. PLATTS. Right.

Mr. MCCONNELL. And then you look at which ones are the ones you need to go after. You make a decision as to why you do not go after this one, and you go after this one. And everybody knows.

Mr. PLATTS. And it is a question at a future hearing. I will probably say where are we today on that window dressing investigation. Have we done that, and if not was it because an evaluation was made? I will understand. But a likely followup.

Mr. MCCONNELL. Right. When would that be?

Mr. PLATTS. The following week. You know, I say that joking, but seriously it is—you know, you are partnering in your opening comment about GAO and that partnership and our subcommittee and our efforts is to, not to play gotcha, but to keep pushing everybody.

Mr. MCCONNELL. We appreciate that. We really do.

Mr. PLATTS. OK.

Mr. MCCONNELL. And that is the way we have operated with your staff in a constructive——

Mr. PLATTS. And I say, for example, including us. Because if you lay out here is the challenge for SEC in today's market environment and here is what we need and here is what we do not have to meet that need, then if Congress does not deliver, that it is pushing up. And that is why you need to be outspoken and be vocal. Those 91, 95 million investors out there, it is critical to their long term economic security that we are proactive, all of us.

Mr. MCCONNELL. I agree.

Mr. TOWNS. Yes. I just want to add that, you know, the fact that there is no plan and the fact that you have all these vacancies and you have to realize that at some point people begin to question. And I think that—and that if you have the slots and you do not fill them—you know in Washington if you do not use them, you lose them. I mean, that has been a longstanding concept. So I do not know in terms of what you need to do, but I think that being there is this need, you need to try to find a way to begin to go out and get people. And you might have to do some things within your own shop to be able to get them and to train them, whatever it needs to be done, you know, you need to just reach out and do that. Because, you know, to have the money and to say that we do not have

the resources which means in terms of the people, I mean at some point people begin to question that.

So I want you to know, I will be honest with you, as close as I have been to this issue I have problems, you know, understanding that part. Knowing that I know it is a difficult time to get accountants because I know all that kind of stuff.

Mr. MCCONNELL. Right.

Mr. TOWNS. But the point is that there must be a way that you can bring them in, because they are out there in some form or fashion.

Mr. MCCONNELL. Right. I agree.

Mr. TOWNS. I give back.

Mr. PLATTS. Thank you, Commissioner Towns.

Mr. Hillman and Mr. McConnell, we again appreciate your participation here today as you try to partner and go forward and push for all of us to in the end look out for the investors. And I use my mom who today, keeps a close eye on her retirement investments.

Mr. MCCONNELL. Right.

Mr. PLATTS. And how those mutual funds are doing. And, that is just a dramatic change in the Nation today versus the 5, 10, 15 years ago. And so the work you are doing is critically important.

And I certainly do echo Mr. Bogle's comments. We salute you and all of the SEC for your diligence. While we are going to keep pushing you, we also respect your hard work and efforts you have put forth for all our investors—I had better stop talking.

So, Mr. Hillman, you as well and GAO and the partnering.

And with regard to committee staff I wanted to commend both staff on both sides for assistance in putting today's field hearing. And again, for arranging for us to be here at Pace University, to Pace University for hosting us. It worked out great.

We will keep the record open for 2 weeks for any additional submissions, otherwise this hearing stands adjourned.

Thank you.

[Whereupon, at 1:37 p.m., the subcommittee was adjourned.]

○